ALWAYS CONSIDER A SECTION 1031 TAX DEFERRED EXCHANGE WHEN SELLING NON-OWNER OCCUPIED PROPERTY

By **Matthew J. Cholewa**
1031 Exchange Officer, First American Exchange Company
Counsel, First American Title Insurance Company
Hartford, Connecticut

Whenever you are selling non-owner occupied property or vacant land, you should consider recommending to your customer that they structure the transaction as a 1031 Tax Deferred Exchange. As this article discusses, structuring a sale as a 1031 exchange can result in financial benefits to both you and your customer.

What is a 1031 Exchange?

A section 1031 Tax Deferred Exchange is an investment and tax deferral strategy that should be considered by every seller of non-owner occupied property. The name comes from section 1031 of the Internal Revenue Code, which reads in part as follows:

> **§1031. Exchange of property held for productive use or investment**
> **(a) Nonrecognition of gain or loss from exchanges solely in kind. —**
>
> **(1) In general. —** No gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind which is to be held either for productive use in a trade or business or for investment.

Section 1031 allows the seller of business or investment property to defer recognizing gain on the sale of the property as long as the seller subsequently acquires another property used for business or investment within the time frames set forth in the IRS code. Recognition of the tax is deferred until some time in the future, usually when the replacement property is sold.

Benefits to Your Customers

A 1031 exchange benefits your customers by allowing them to defer the payment of capital gains taxes, thereby increasing their buying power. This is because funds that would otherwise have been paid to the IRS can instead be reinvested in replacement property. This can best be illustrated through a simple example.

First, Let’s keep a few rules in mind. Taxes are due on all capital gains. The maximum long-term capital gain rate for individuals is currently fifteen percent (15%) of the gain. Also, depreciation taken during ownership must be recaptured when property is sold. Depreciation recapture is taxed at twenty-five percent (25%) regardless of one’s tax bracket. Finally, capital gains are taxed as income in Connecticut, generally at five percent (5%).

Assume the following: Your customer has owned qualified property for many years that she purchased for $100,000 and which has an existing mortgage balance of $50,000. She made no capital improvements and took $50,000 in depreciation deductions on the building located on the property. She is now selling the property for $200,000.

If she sold the property and paid the taxes, she would have to pay (i) $12,500 for the depreciation recapture (twenty five percent of $50,000), (ii) $15,000 in federal income taxes for the $100,000 in appreciation (fifteen percent of $100,000), and (iii) $5,000 in state income taxes (five percent of $100,000), for a total of $32,500 in taxes. After paying off her mortgage, that would leave her with net proceeds of $117,500 to reinvest.

If, however, she structures the sale of the property as a section 1031 tax deferred exchange, she would defer the payment of the above taxes and would have proceeds of $150,000 to reinvest.

Let’s assume your customer is able to secure seventy-five percent (75%) financing for her replacement property. Without doing the 1031 exchange, she would be able to use her $117,500 proceeds to purchase property worth $470,000. If she instead structures her sale as a 1031 exchange, she would be able to use her $150,000 in proceeds to purchase property worth $600,000.

Benefits to You

Why should a real estate agent learn about 1031 exchanges? The most immediate reason is that you can put yourself in a position to suggest an investment strategy that is of immediate financial benefit to your customer. And of course, happy customers lead to more referrals. Also, you can potentially ***double your commissions*** by increasing the chance of your customer purchasing a replacement property and securing the commission on that purchase.

You should recommend considering a 1031 exchange whenever the seller does not live in the property. Small investors often overlook the possibility of a 1031 exchange because they assume that 1031 exchanges are limited to substantial commercial properties. Most exchanges, however, involve the sale of residential investment properties selling for less than $300,000.

When is it too Late to do a 1031 Exchange?

A 1031 exchange has to be set up before the closing of the relinquished property. Once the closing has occurred, your customer has missed the opportunity to do a 1031 exchange.

The best time to recommend a 1031 exchange is when you take the listing.

The IRS Rules

Most exchanges are conducted as "deferred exchanges," where the relinquished property is sold to one party and the replacement property is subsequently purchased from another party. This requires that the taxpayer employ the services of a ***qualified intermediary***, who must be disinterested in the transaction (this normally disqualifies the taxpayer's attorney, accountant or real estate agent). The qualified intermediary prepares certain documentation necessary for the exchange transaction and holds the exchange proceeds from the time the relinquished property is sold until a replacement property is purchased. ***First American*** handles like-kind exchanges from its Hartford, Connecticut office through its affiliate, ***First American Exchange Company, LLC***, which acts as a 1031 qualified intermediary.

1031 exchanges are authorized by section 1031 of the Internal Revenue Code. To properly conduct an exchange, the Code and IRS regulations must be strictly followed. The most important rules to remember are the timing rules. Once the relinquished property is sold, the taxpayer must identify potential replacement property within 45 days and acquire the replacement property within 180 days.

Another requirement of a 1031 exchange is that the relinquished and replacement properties be ***"like kind."*** This is important if someone is exchanging personal property (like an airplane or a yacht). With real estate, however, this requirement is easy to satisfy, since the Code treats most real property interests as like kind with other real property. Thus, farmland can be exchanged for an apartment building, a shopping center for residential condominium units.

Finally, there are three rules to keep in mind that allow taxpayers to fully defer their gain. First, the taxpayer should acquire replacement property of equal or greater value than the relinquished property. Second, the taxpayer should not take any cash out of the transaction (that is, all the equity from the relinquished property should be invested in the replacement property). Failure to follow these two rules can result in all or part of the gain being taxed as "boot." Third, the taxpayer who sells the relinquished property must be the same taxpayer who purchases the replacement property. So, for example, a problem will arise if a taxpayer holds title to the relinquished property in his own name and wishes to take title to the replacement property in his corporation, because the corporation is a taxpaying entity distinct from the taxpayer.

Reverse and Construction Exchanges

Beyond the "deferred" 1031 exhanges described in this article, there are other types of more complicated exchanges. In a ***reverse exchange***, the taxpayer, through an intermediary and an Exchange Accommodation Titleholder ("EAT"), acquires the replacement property before selling the relinquished property. The taxpayer must have the financial resources available to fund the purchase of the replacement property prior to the sale of the relinquished property. In a ***"build to suit"*** or ***"construction"*** exchange, the taxpayer sells property and, again using an EAT, acquires replacement property on which he will construct improvements. This type of exchange allows the taxpayer to use the exchange funds to not only buy the property but also to construct improvements. The exchange still must be completed with the 180 day period noted above. In both reverse exchanges and construction exchanges, the intermediary, using an EAT, takes title to the replacement property and eventually conveys it to the taxpayer. In a deferred exchange, the intermediary does not need to take title to either the relinquished or replacement property.

Choosing a Qualified Intermediary

When choosing a qualified intermediary for a 1031 exchange, the intermediary's financial credentials, experience and nationwide service are of primary concern. Keep in mind that the qualified intermediary is holding the exchange proceeds between the sale of the relinquished property and purchase of the replacement property. Further, the qualified intermediary should deposit the exchange proceeds in highly liquid, segregated accounts for the benefit of your customer. Exchange Funds held by First Amerian Exchange Company are strictly deposited in segregated accounts with FDIC insured institutions with investment grade ratings (or which are subsidiaries of investment grade institutions). We do not invest exchange funds in any securities. We operate as a direct subsidiary of First Amerian Title Insurance Company which means that in many instances we can provide an indemnification letter protecting the taxpayer 's transaction from loss of funds in the unlikely event of negligence, fraud or dishonesty on the part of First American Exchange Company or its employees. In addition, we maintain a multi-million dollar fidelity bond and a professional liability policy from an independent insurance underwriter.

Another important consideration is the accessibility of the qualified intermediary. We have attorneys and Certified Exchange Specialists on our staff throughout our offices nationwide and a local presence in Hartford, Connecticut.

Matthew J. Cholewa is a 1031 Exchange Officer with First American Exchange Company and Counsel with First American Title Insurance Company in Hartford, Connecticut. He can be reached at 860-466-5420 or via email at *mcholewa@firstam.com*