What is a 1031 Exchange?

In a typical property sale, the seller must pay taxes on any gain. As an alternative, a 1031 exchange offers financial and tax advantages to an investor or property owner. By following the provisions outlined in Section 1031 of the Internal Revenue Code, a taxpayer may exchange property – used in a trade or business or held for investment – for like-kind property, and defer payment of taxes on any gain. Simply put, an exchange allows a taxpayer to sell a property and acquire another qualified property without paying any tax.

The IRS has established technical guidelines that must be followed when structuring an exchange. The primary steps in the process are:

- **Selling Qualified Property** – Taxpayer owns and decides to sell (relinquish) qualified investment property(s) that, when sold, would produce a taxable consequence.
- **Before Relinquished Closing** – Prior to or at the closing of the sale, the taxpayer engages the services of a Qualified Intermediary (QI) or Facilitator to convert the sale into a 1031 exchange.
- **Relinquished Closing** – QI forwards instructions and required documents to the closing. The proceeds are disbursed to the QI.
- **Restricted Access to Funds –** The regulations stipulate that the taxpayer may not have actual receipt or control of the proceeds, use the proceeds as collateral or otherwise have the benefit of the funds during the exchange process. These restrictions should be spelled out in the exchange document.
- **Required Timeframes –** Taxpayer must identify potential like-kind replacement property(s) within 45 days and acquire one or more of the property(s) within 180 days. The start of both time frames is the same-the day after the relinquished closing.
- **Value of Replacement Property –** The price of the property(s) acquired under contract must equal or exceed the price of the property sold. All proceeds must be used in the acquisition to have no tax consequence.
- **Replacement closing –** Taxpayer puts replacement property(s) under contract and contacts the QI, who forwards instructions and required documents, along with the funds, to the closing.
- **Close Out –** At the end of the exchange or the 180-day period, the QI closes out the exchange and forwards any remaining proceeds and interest payout with an accounting of the transaction.

Why consider an exchange?

There are a variety of reasons why a property owner should consider an exchange. However, all of the reasons share a common benefit – when properly structured, a 1031 exchange allows a property owner to reinvest all of the proceeds without tax consequences, which usually creates a greater overall return.