

AN INTRODUCTION TO THE BENEFITS OF §1031 TAX DEFERRED EXCHANGES



EXCHANGES ARE A POWERFUL TAX STRATEGY

Compliments of

Tax deferred exchanges have been a part of the tax code since 1921 and are one of the last significant tax advantages remaining for real estate investors. One of the key advantages of a §1031 exchange is the ability to dispose of a property without incurring a capital gain tax liability, thereby allowing the earning power of the deferred taxes to work for the benefit of the investor (called an "Exchanger") instead of the government. In essence, it can be considered an interest-free loan from the IRS.

BASIC TAX EXCHANGE REQUIREMENTS

The IRS allows up to a maximum of 180 calendar days between the sale of the relinquished property and the purchase of the replacement property. Within the 180 day "exchange period," the investor must also properly identify suitable replacement properties within 45 calendar days of closing on the sale of the relinquished property. There are a number of requirements which need to be met to qualify for tax deferral under the tax code:

Requirement #1: Both the "relinquished" and "replacement" properties must be held for investment or used in a business. The IRS uses the term "like-kind" to describe the type of properties that qualify. Any property held for investment can be exchanged for any other "like-kind" property held for investment. This definition covers a vast variety of developed and undeveloped real estate. Properties which are clearly not like-kind are an investor's primary residence or property "held for sale."

The relinquished and replacement properties need not have identical functions (i.e. both be residential rentals or commercial strip centers). The key issue is that the Exchanger can substantiate that both properties were "held for investment."

Requirement #2: The IRS requires an investor to identify the replacement property(s) within 45 days from closing on the sale of a relinquished property. The 45 day Identification Period begins on the closing date, and the replacement property(s) must be properly identified in a letter signed by the Exchanger. Exchangers have a number of ways to properly identify properties. They may identify up to three replacement properties without regard to their total fair market value (Three Property Rule). Alternatively, they can identify an unlimited number of replacement properties, if the total fair market value of all properties is not more than twice the value of the property sold (200% Rule). An Exchanger can not meet either of these rules if they acquire 95% of the aggregate fair market value of all identified replacement properties.

(Read Part 2 to learn more about exchanges.)



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