1031 Transactions For Commercial And Residential Real Estate

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We have seen a steady increase in activity and price levels for both commercial and residential real estate since the start of the year. Property owners are finding this an opportune time to sell which is resulting in a resurgence of 1031 transactions. I.R.C. 1031 is a provision in the IRS code which enables property owners (only for investment properties) to take all of the proceeds from a sale and use them to acquire another investment property and defer paying all gains taxes (both State and Federal).

The purpose of this mechanism is to enable investors to have more capital to increase their purchase price power and thus accumulate more wealth. When the investor then decides to sell and not purchase another property, then the gains taxes will be due.

A 1031 transaction works in the following steps:

1) **Notification (45 Days):** The sale of an investment property is labeled as the "relinquished property" and the property to be purchased as a result of the 1031 is a "replacement property." Once the closing for the relinquished property has taken place, all funds (with the exception of adjustments) have to be made out to a 3rd party 1031 intermediary and the intermediary holds those funds in escrow. The investor then has 45 days from the date of the closing of the relinquished property to notify the intermediary of its intended replacement property. There are three ways in which one can identify a property:

   1) *3-Property Rule* (most common) where the maximum number of replacement properties you may identify is three properties without regard to the fair market values of the properties;

   2) *200 Percent Rule* (fairly utilized) where you may identify any number of properties as long as their total fair market value does not exceed 200 percent of the total fair market value of all relinquished properties, and

   3) *95% Rule* (least common and most complex) where there is no limit as to the total (aggregate) number or value of identified like-kind replacement properties permitted under the 95% exception as long as you actually acquire and close on 95% of the value identified.

2) **Closing of Replacement Property (180 days):** The closing of the replacement property must take place within 180 days from the sale of the relinquished property. All of the proceeds from the sale must be used on the purchase of the replacement property. The proceeds from the sale can be used to pay a portion of the purchase price of multiple replacement properties with the rest of the purchase price being financed or paid by the investor themselves, as long as all of the proceeds from the sale are used to purchase like-kind property within the 180 day period. A partial exchange is permissible. In this situation the investor will pay capital gains on whatever money they pull out for themselves and the money that they intend on using for the 1031 exchange must be held by the qualified intermediary.

3) **"Like-Kind Exchange":** the replacement property must be a like-kind property. "Like-Kind" is a federal tax term relating to the nature or character of the real estate in the hands of the owner rather than to its grade or quality. The fact that the real estate is improved or unimproved is not material, for that fact relates only to the grade or quality of the property and not to its kind or class. Qualified real estate located in the 50 United Sates is of like-kind when exchanged for other qualified real estate located in the 50 United States and the U.S. Virgin Islands. Foreign real estate does not qualify as like-kind property. A 1031 exchange can have a residential property and commercial property as the relinquished and replacement property as well as vice versa.

4) **"Use Test" (properties which qualify for a 1031):** Only property held for business or investment purposes can be used in a 1031. Primary residences or second homes do not qualify for a 1031 exchange. A vacation home or second home not held as a rental is classified as real estate held for personal use and does not qualify for 1031 treatment. However, a dwelling unit held for both personal use and rental purposes must take a "use test" each tax year to determine its tax classification for that tax year. The property is treated as rental property if the owner's personal use is no more than 14 days or 10% of the rental days during the tax year and the property is rented more than 14 days during the tax year.

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