NAS Investment Solutions

1031 A Guide Through the Tax Deferred Real Estate Investment Process

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NAS Investment Solutions

Please note that this guide is intended to familiarize the reader with the basic framework and purpose of a 1031 exchange. It is not intended to provide specific legal advice. Anyone planning on engaging in a 1031 "like-kind" exchange should consult an attorney, tax advisor, and a licensed, bonded, and experienced 1031 exchange intermediary company.

Dear Friends,

I am so proud to be part of a hard-working and experienced group of people who are committed to always putting our clients first with a superior level of service, professionalism, ethics and objective, transparent communication.

We believe that well-informed clients are the best members of our client family. With this in mind, we have developed the following straightforward, unbiased guide through the often-challenging, 1031 Exchange process.

Whether you are an investor unfamiliar with the process or have extensive experience with tax-deferred investments, we hope the following guide serves as a valuable educational and reference tool for you.

Please feel free to reach out to us with any questions you may have or suggestions on how we can improve upon this guide and our website, nasinvestmentsolutions.com

Sincerely,

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1031 Exchange Property Investments

A Guide to Tax-Deferred Real Estate Investing

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Introduction

The phrase 'Section 1031' is slowly making its way into everyday use. Real estate agents and investors, banks and title companies, and even the next-door neighbor probably have heard about this section of the Internal Revenue Code.

Most people are familiar with how 401(k) plans work – perhaps one of the best-known sections of the IRS Code – because it relates to workplace retirement savings plans. But many real estate investors still have questions about exactly what a 1031 tax-deferred exchange is, the guidelines and timelines of a 1031 exchange, and how to defer the payment of capital gains tax using a 1031.

What is a 1031 Exchange?

A 1031 exchange is a legal process that allows real estate investors to defer the payment of capital gains taxes.

The process is also sometimes called, a 'Tax-Deferred exchange', a 'Like-kind exchange', or simply a '1031'. Regardless of the term used, a 1031 exchange originates from Section 1031 of the U.S. Internal Revenue Code.

This section of the Code allows investors to sell or relinquish an investment property, reinvest the proceeds in a replacement investment property of like-kind and greater or equal value, and defer the payment of any capital gains tax. To qualify for deferment of capital gains tax payment, the investor must follow the exact steps outlined in Section 1031, and the exchange must be done within specified time constraints.

Reasons for Doing a 1031 Exchange

The biggest advantage of using a 1031 exchange to sell one investment property and buy another is that the payment of capital gains tax is deferred.

Although there is no minimum hold-time with a 1031 exchange, real estate is usually a long-term investment and held for longer than one year. By deferring a capital gains tax payment, investors free up more capital for investment in income-producing real estate.

In addition to deferring the payment of capital gains tax, there are several other reasons why real estate investors might consider using a 1031 exchange to sell one investment property and buy another. They include, but are not limited to:

- a low return and purchasing one with higher anticipated returns
- Diversifying a real estate investment portfolio with different properties in different asset classes or geographic locations
- Exchanging a property that is being self-managed by the investor for a larger property that is managed by a professional third-party property management company
- Consolidating several smaller properties into one large property, or divide a single large property into several smaller ones, often for the purposes of estate planning
- Avoiding the recapture of depreciation and the resulting increase in taxable income

Types of Property That Can Be Exchanged

Section 1031 of the Internal Revenue Code describes the type of qualified properties that can be exchanged as follows:

"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."

Based on the above description from the IRS, there are two key property requirements for a 1031 tax-deferred exchange:

<u>Like-kind Requirement</u>

Both the property being sold, or sold, and the new Replacement Property must be 'like-kind'. Real estate property that has been used in the taxpayer's trade or business qualifies as like-kind property. A personal residence does not qualify as like-kind property because it isn't held for business or trade purposes.

Some examples of like-kind property exchanges that meet the requirements of Section 1031 include:

- A single-family rental home, townhouse, or condominium for a larger multifamily property such as a duplex, triplex, or apartment building
- An office building or a shopping center, warehouse or industrial property, or a multifamily property, for another office building
- A hotel for a farm or ranch
- An apartment building for a hotel
- A residential rental property for a warehouse or distribution building
- A parking lot or garage for a marina

Unimproved raw land and improved subdivided land are also considered like-kind properties for investment purposes, provided the land is held as an investment. For example, a commercial property such as a shopping center or warehouse could be exchanged for raw land, or improved land could be exchanged for a hotel or multifamily property.

Investment Requirement

The IRS also requires that both the Sold Property and the Replacement Property must be held for investment or business purposes to qualify for tax-deferred treatment. An investor could not sell a primary personal residence to purchase an investment property and expect to receive tax-deferred treatment under Section 1031. By the same token, a 1031 exchange could not be used to relinquish an investment property and acquire a primary home.

Recent Changes to Like-Kind Property

Prior to December 31, 2017, like-kind property included a wide range of real and tangible property held for business or investment purposes. Franchises, art work, equipment and machinery, furniture and fixtures, stock-in-trade, securities, and partnership interests are some examples. Investors using 1031 exchanges prior to 2018 could defer the payment of capital gains tax by relinquishing an office building or other real estate holding and acquiring a valuable piece of art.

However, the Tax Cuts and Jobs Act of 2017 that was signed into law on December 22, 2017 repealed the use of Section 1031 for all other types of property except real estate property.

Different Types of Like-Kind Exchanges

Under Section 1031, real property is considered like-kind based on its nature or characteristics, not the quality of the property. For example, raw land can be exchanged for an existing office building, or an industrial warehouse can be sold and replaced with a multifamily apartment building.

This creates a wide variety of exchangeable property that can be sold and replaced. There are three different types of like-kind exchanges, each varying slightly in order of process and detail, with specific sets of procedures and requirements that must be followed to defer the payment of capital gains tax.

Delayed Exchanges

The delayed 1031 exchange carried out within 180 days is the most common tax-deferred exchange. This exchange is called a ”delayed exchange” because, prior to 1979, the exchange had to occur simultaneously with sale (relinquishment) and purchase (acquisition) occurring at the same time. While simultaneous exchanges can occur and receive tax-deferred treatment, because of the timing involved, they are more the exception than the rule.

In 1979 the rule was modified to allow for deferred exchanges.

There are three steps to a delayed 1031 tax-deferred exchange:

- **Step 1:** Complete sale of the property being sold with the sales proceeds accepted by a Qualified Intermediary (QI)
- **Step 2:** Within 45 days of the sale of the Sold Property, identify one or more replacement properties
- **Step 3:** Within 180 days of the sale of the Sold Property, complete the purchase of the Replacement Property (or properties) with the Qualified Intermediary transferring

the Sold Property proceeds to the seller of the Replacement Property

Build-to-Suit Exchanges

A build-to-suit 1031 tax-deferred exchange allows the Replacement Property to be renovated or newly built. Owner-users of investment property for business are one of the main users of Build-to-Suit Exchanges.

Build-to-Suit Exchanges are subject to the same 180-day completion time frame that Delayed Exchanges must follow. Just as importantly, all improvements and construction on the newly built property must be completed within the 180-day window in order to qualify as part of the tax-deferred exchange. Improvements that are completed outside of the 180-day time period are considered personal property whose value will not qualify as part of the exchange.

Reverse Exchanges

Reverse tax-deferred exchanges are the opposite of Delayed Exchanges.

With a Reverse Exchange an investor acquires the Replacement Property before an existing property is sold. In a Reverse Exchange the real estate investor cannot immediately take possession of the newly purchased property. Instead, the Replacement Property must be held by an exchange accommodation titleholder or a Qualified Intermediary until the Reverse Exchange is complete.

The investor must also have a signed Qualified Exchange accommodation agreement as evidence of the intent to perform a 1031 Tax-deferred Exchange.

Here are the steps of a reverse 1031 tax-deferred exchange:

- **Step 1:** Purchase Replacement Property before the existing property is sold, with an exchange accommodation titleholder or Qualified Intermediary holding the Replacement Property on behalf of the investor
- **Step 2:** Within 45 days of the purchase of the Replacement Property, identify the property to be sold
- **Step 3:** Within 180 days of the Replacement Property purchase, complete the sale of the Sold Property, with the exchange accommodation titleholder or Qualified Intermediary transferring the Replacement Property to the investor

Reverse tax-deferred exchanges are often used by real estate investors who locate a hard-to-find property and need to move quickly, or by owner-users in lieu of conducting a Build-to-Suit Exchange. Using the previous example of the distribution company, the firm may find the ideal larger facility for its business and decide to purchase the Replacement Property quickly before a competitor does.

General Rules and Guidelines for 1031 Exchanges

In the remaining sections below, we'll review some of the options that the Internal Revenue Code gives investors when conducting 1031 tax-deferred exchanges. But, regardless of the type of 1031 exchange an investor chooses, there are several general rules and guidelines that apply to all IRS Section 1031 exchanges:

<u>Same Taxpayer</u>

Any taxpayer, such as an individual, partnership, LLC, trust, or corporation, can conduct a 1031 tax-deferred exchange.

However, the IRS requires that title to the Replacement Property must be held the same way that title to the Sold Property was held. That's because a 1031 exchange is considered – at least for tax purposes, since payment on capital gains tax is being deferred – to be a continuation of the original investment. Because of that, the title must reflect the continuation of the investment with the Replacement Property.

Holding for Investment Purposes

Real estate sold (relinquished), and replaced (acquired), with a Section 1031 tax-deferred exchange, must be held for investment or business purposes. Some examples of holding real property for investment purposes include:

- Raw land held in the path of future freeway development
- Shopping center owned as part of an income-generating real estate portfolio
- Warehouse owned and occupied by a distribution company

Primary residences are not eligible for tax-deferred exchanges because they are not held for business or investment purposes. So, an investor could not sell his primary residence to buy another shopping center, nor could the owner of the distribution company sell the warehouse and buy a primary residence, using a tax-deferred exchange.

U.S. and Foreign Property Restrictions

Beginning in July 10, 1989, real estate held for business or investment purposes in the United States must be exchanged with like-kind real property in the United States in order to qualify for deferral of capital gains tax payment. Because U.S. income is taxed worldwide, Section 1031 allows foreign property to be exchanged with other foreign property.

Private letter rulings and case law supports exchanging like-kind property from the U.S. states and U.S. territories. Current U.S. territories are American Samoa, Guam, Northern Mariana Islands, Puerto Rico, U.S. Virgin Islands, Bajo Nuevo Bank, Baker Island, Howland Island, Jarvis Island, Johnston Atoll, Kingman Reef, Midway Islands, Navassa Island, Palmyra Atoll, Serranilla Bank, and Wake Island.

However, because deferred exchanges involving real estate in U.S. territories varies on a case-to-case basis, it is always best for investors to consult with a Qualified Intermediary or tax advisor familiar with both U.S. and international law.

<u>Stock in Trade</u>

Real estate that is held primarily for resale is considered to be stock in trade held by a dealer, and generally does not qualify for a 1031 exchange. For example, houses or condominiums built by a real estate developer and offered for sale, and fix-and-flip or wholesale investors who sell property as soon as it is improved or fixed up, may be considered dealers in the eyes of the IRS.

The Internal Revenue Code has no clear guidelines as to what does and doesn't constitute a dealer. Instead the IRS considers three things to determine if real estate is used for stock or for investment:

- Purpose and motivation behind the acquisition and use of the real property
- Length of time the real estate is held
- Principal business of the owner buying the property

Qualifications to Defer Some or All Capital Gains Tax

Real estate investors must follow seven rules to qualify to defer some or all capital gains tax:

1. Property must be like-kind real estate of the same nature or character, but can differ in type, quality or grade
2. Real estate must be used for investment or business only, not as personal property or not as a primary residence
3. Property must be of equal or greater value, including both the total sale price and replacement of an equal mortgage amount (if a mortgage exists)
4. Investor must not receive boot (Described in the next section)
5. Title of the Sold Property and the Replacement Property must be in the same taxpayer name
6. Replacement Property must be identified within 45 days of closing on the sale of the Sold Property
7. Purchase of the Replacement Property must occur within 180 days of closing on the sale of the Sold Property

Investors sometimes make the mistake of thinking that 180 days is the same thing as six months. Real estate investors using 1031 tax-deferred exchanges should note that the IRS counts individual days, inclusive of weekends and holidays, when calculating the 180-day purchase window period.

Receipt of Boot

If the value of the Sold Property is greater than the value of the Replacement Property, the difference in value between the two is called 'boot'. Other items given or received in a 1031 exchange transaction such as cash, liabilities, intangible goodwill, or personal property that are not like-kind real estate are also considered boot. Capital gains tax must be paid on the boot for the year the 1031 exchange takes place.

However, there are a number of expenses and fees that can be paid with exchange funds that will affect the value of a tax-deferred exchange transaction and the potential boot as well:

- Broker sales commissions and finder fees
- Qualified Intermediary fees or exchange accommodation titleholder fees
- Filing fees
- Attorney fees
- Title insurance premiums and escrow fees
- Tax adviser fees related to the 1031 exchange

The following are expenses and fees that are property-specific and not part of the cost of conducting a 1031 tax-deferred exchange transaction and therefore cannot be paid with exchange funds and cannot be used to affect the value of any potential boot:

- Mortgage-related financing fees
- Property taxes
- Property insurance premiums
- Repair or maintenance costs

1031 Tip

Be careful of Non-Permissible Operating Costs, Financing Costs and Closing that will cause "taxable boot". Always consult with a legal, tax and financial advisor prior to closing on a 1031 exchange so they may review a draft closing statement to ensure potentially taxable items are handled appropriately. Certain costs like prorated property taxes, prorated rents, insurance premium payments, security deposits, and other operating costs should either be handled outside of escrow or be funded with operating cash at close. If you use gross proceeds to cover these items, you may have "taxable boot".

Mortgages

Real estate with an existing mortgage loan can be used as part of a tax-deferred exchange. However, investors need to be careful not to accidentally incur boot when selling and replacing property with a mortgage.

For example, if a property being sold has an existing mortgage loan of $750,000 and the mortgage on the Replacement Property is only $500,000 the investor will have a gain of $250,000. This difference between the old and new mortgage is classified as boot and is subject to payment of capital gains tax.

"Touching" the Money

Sellers cannot take possession of the money between the sale of the property being sold and the Replacement Property being purchased. If they do, they have 'touched the money' and created 'boot', voiding their opportunity to defer paying capital gains on the transaction.

Taxpayers use an independent third party known as an exchange intermediary or a Qualified Intermediary or an Accommodator to hold all of the sales proceeds from the Sold Property and to disburse those funds when a Replacement

Property is replaced. By law, the exchange intermediary has very specific functions which we discuss in detail in the section on Qualified Intermediaries near the end of this Guide.

Related Party Transactions

Under Internal Revenue Code Section 1031 the Internal Revenue Service defines related parties as:

- Family members including full and half siblings, spouses, ancestors, and direct lineal descendants
- A corporate entity which has more than 50% of its stock owned by a family member
- A grantor and a fiduciary of a common trust
- A fiduciary and a beneficiary of a common trust
- Other corporate entities such as IRC Section 501 organizations, executors, and beneficiaries of a common estate

Historically taxpayers have bought and sold real estate from related parties with no restrictions or penalties. However, over the years, the IRS learned that many related parties were using tax-deferred 1031 exchanges to shift and increase basis in a property to gain a tax advantage before selling the property.

The IRS doesn't prohibit tax-deferred 1031 exchanges between related parties, but it does set two restrictions to related party transactions:

1. If a property is sold to a related party, or replaced from a related party, the property will not qualify for capital gains tax deferral if it is sold or otherwise disposed of within two years from the date of the tax-deferred transaction

2. A Replacement Property replaced from a relative does not qualify for tax-deferred treatment if the related person receives cash or other personal property in the transaction

Subsection 1031(g) of the Code does provide some exceptions to the two-year holding rule. In general, though, investors should remember the two-year rule when involved in an exchange with a related party to avoid being accused of a basis shifting transaction by the IRS.

Identifying a Replacement Property & Timing Deadlines

Real estate investors who want to receive the full benefit of a 1031 tax-deferred exchange should acquire Replacement Property (or properties) of greater or equal value to the property being sold. Doing this not only maximizes the amount of capital gains tax deferral but avoids paying capital gains tax on property 'boot'.

Identifying a Replacement Property means having a written purchase contract accepted by the seller of the Replacement Property. The purchase contract will have a contingency or cooperation clause noting that the property will be replaced through the buyer's 1031 exchange.

Here is an example of common wording used for a cooperation clause used in a purchase contract for the Replacement Property:

"Seller is aware that the buyer intends to complete a 1031 exchange through this transaction and hereby agrees to cooperate with buyer to accomplish the same, at no additional cost or liability to the seller."

(The cooperation clause in a purchase contract used to relinquish property would substitute the word ‘seller’ with ‘buyer’.)

Because buyers can identify more than one Replacement Property, the buyer may include in the contract that earnest money is fully refundable should the purchase contract be cancelled by the buyer. Sellers on the other hand are often cautious of putting their property under contract, and effectively taking it off the market, for a buyer who may be making an offer to purchase simply to increase its number of Replacement Property options.

There are three rules that IRC Section 1031 applies to identifying a Replacement Property. Investors only need to follow one of these three rules:

<u>Three-Property Rule</u>

The three-property rule allows investors to identify up to three potential replacement properties for the property being sold, regardless of their market value. Only one of the three replacements must be purchased.

Investors in income-producing real estate (as opposed to owner-users such as our small distribution company) often make use of the three-property rule to tie replacement options up before having to make a final decision on which property to acquire.

<u>200% Rule</u>

The 200% rule allows the investor to identify an unlimited number of replacement properties provided that the combined total value of these properties does not exceed 200% of the value of the property being sold.

Real estate investors seeking to diversify their portfolio often use the 200% rule. For example, the owner of a large multi-tenant shopping center may choose to diversify an investment portfolio by geography and asset class by relinquishing the shopping center and acquiring several single-family rental homes in different markets throughout the U.S.

<u>95% Rule</u>

The 95% rule also allows real estate investors to identify an unlimited number of replacement properties for the property being sold. But unlike the 200% rule that puts a limit on the total value of the identified replacement properties, the 95% rule requires the investor to actually purchase 95% of the aggregate value of the replacement properties identified.

Let's consider the shopping center owner from our example above. The investor still wants to diversify its portfolio geographically but isn't sure what asset class to acquire replacement properties in. So, the investor identifies single-family rentals, office buildings, and shopping centers in several markets as Replacement Property under the 95% rule.

While it might sound like a good way of keeping options open, the 95% rule does come with potential unintended consequences that can create a larger purchase commitment than intended. For example, assume the shopping center sells for $5 million and the investor identified properties worth a total of $8 million. The investor would have to purchase at least $7.6 million (95%) worth of the identified properties.

Regardless of which tax-deferred exchange Replacement Property rule investors choose, the timing is always the same:

1. Identify a Replacement Property within 45 days of the original property being sold

2. Close on the Replacement Property within 180 days of the original property being sold

Avoiding Boot with Additional Cash

When the value of the Replacement Property is less than the value of the Relinquished Property, the difference in value between the two is called boot. Any boot that an investor receives when conducting a 1031 exchange is subject to capital gains tax that cannot be deferred as part of their 1031 transaction.

Sometimes – despite an investor's best intentions – boot happens.

To avoid creating boot in a 1031 exchange and having to pay capital gains tax on the boot, the investor would have to add additional cash to the transaction. The investor's Qualified Intermediary would assist on this.

Depreciation and 1031 Exchanges

Depreciation is also an important concept for understanding another key benefit of a 1031 exchange.

Tax law allows a certain percentage of investment property to be depreciated – or written off – each year to recognize the effects of wear and tear on the property. Depreciation is a non-cash expense that allows real estate investors to reduce the amount of total taxable net income. Depreciation expense is also one of the main tax benefits investors receive from owning investment real estate.

When real estate is sold, the property's net-adjusted basis must be calculated to determine the amount of capital gains tax owed. Net-adjusted basis is calculated by adding the original purchase price of the property together with capital improvement, then subtracting the amount of depreciation. If a property sells for more than its depreciated value, depreciation must be recaptured and included as part of the taxable income from the property sale.

The longer an investor holds a property, the more it is depreciated, which also means the amount of depreciation that must be recaptured also increases over time. Real estate investors often use a 1031 exchange as a tool to avoid the increase in taxable income that the recapture of depreciation creates.

Depreciation recapture is always a factor in calculating the value of a property being sold through a 1031 exchange. The degree to which depreciation plays a role varies from investor to investor and is a main reason why real estate investors utilize the services of professionals for 1031 exchange transactions.

LLCs and Tenancy in Common Exchanges

Limited liability companies can only exchange property as an LLC. That is because 1031 exchanges are always conducted by a single taxpayer or entity on one side of the transaction, in this case the LLC.

It may be possible to complete your own individual 1031 Exchange if you are a member of and LLC, however, the procedure for doing so is complex and varies from entity to entity and state to state, therefore an experienced and skilled professional such as legal counsel, a tax advisor should be engaged by the individual investor to determine if this strategy is applicable to their situation.

Qualified Intermediaries

Real estate investors involved in a 1031 exchange cannot receive (or touch) money from the Sold Property that is used to purchase the Replacement Property. By law, the taxpayer must use the services of a Qualified Intermediary.

Qualified intermediaries are independent third parties. If a party has a family relationship with the taxpayer or has had a business relationship during the preceding two years, they are considered to be a 'disqualified party' and cannot act as a Qualified Intermediary.

Qualified intermediaries in 1031 tax-deferred exchanges serve three main functions:

1. Prepare documents the IRS requires for the sale of the Sold Property and for the purchase of the Replacement Property
2. Hold the sales proceeds from the Sold Property in a trust account and transfer those funds to pay for the Replacement Property when the transaction is completed, never allowing the taxpayer access to the funds
3. Pay the taxpayer any interest earned from the funds being held during the escrow period with the taxpayer liable for reporting any interest received as ordinary income

Qualified intermediaries in 1031 tax-deferred exchanges can incur a large amount of potential liability if they make an error. The IRS will disallow a tax-deferred exchange if the 1031 documents are improperly prepared, creating a capital gains tax liability of tens or even hundreds of thousands of dollars for the taxpayer.

A reminder that taxpayers cannot be their own intermediary

It's worth repeating that taxpayers who attempt to act as their own intermediary will also have their 1031 tax-deferred exchange disqualified by the IRS and be liable for paying capital gains tax on their transaction.

Even if an investor has funds from a Sold Property wire transferred directly to a title company to hold for the purchase of a Replacement Property, the IRS will still disallow the tax-deferred exchange. Although the investor never touched the funds, he still exercised control over the funds, thus making himself liable for the payment of capital gains tax.

How a 1031 Exchange is Accomplished

There are eight steps common to any Section 1031 tax-deferred exchange:

- **Step 1:** Retain the services of a certified public accountant or an attorney with tax-deferred exchange experience
- **Step 2:** Enter into a 1031 exchange agreement with a Qualified Intermediary, being sure to name the Qualified Intermediary as the principal in the sale of the Sold Property and in the purchase of the Replacement Property
- **Step 3:** Sell the Sold Property, making sure to include a cooperation clause requiring the buyer to cooperate with the seller's 1031 exchange, and instruct the escrow officer or closing agent to order exchange documents from the Qualified Intermediary
- **Step 4:** Escrow closes on the Sold Property, with the closing statement showing the Qualified Intermediary as the seller, and sales proceeds from the Sold Property are

sent to the intermediary and placed in a separate segregated trust account

- **Step 5:** Within 45 days of the close of escrow of the Sold Property the taxpayer identifies one or more replacement properties and sends written notice of this to the Qualified Intermediary
- **Step 6:** The taxpayer executes a purchase contract with the seller of the Replacement Property, making sure the cooperation clause is included in the purchase contract, and naming the Qualified Intermediary as the buyer of the Replacement Property
- **Step 7:** Within 180 days of the close of escrow of the Sold Property, the taxpayer instructs the Qualified Intermediary to transfer funds to close and send 1031 exchange-related documents to the escrow company, and the sale closes with the closing statement showing the Qualified Intermediary as the buyer
- **Step 8:** The taxpayer reports the 1031 exchange to the IRS when filing his normal tax returns

After the Replacement Property has closed escrow the Qualified Intermediary will send a final accounting statement to the taxpayer. The statement will show that funds have come from one escrow directly into another, all without the taxpayer having constructive receipt of the funds.

Real estate investors should note that although the Qualified Intermediary is indicated as the seller and buyer on the purchase contracts, the deed and title are always from the taxpayer to the buyer, and from the seller to the taxpayer.

Reporting the 1031 Exchange

1031 exchanges must still be reported to the IRS by the taxpayer even though tax payment is deferred, and no gain or loss is being recognized:

- Form 8824 is used to report like-kind exchanges
- Form 8824 instructions explain in detail how to report a 1031 exchange to the IRS
- Boot received from a difference in value or mortgage amounts between the Sold Property and the Replacement Property is reported on Form 8949 of Schedule D (Form 1040) or on Form 4797, whichever is applicable to the investor

If depreciation is recaptured, resulting in a recognized gain, it may need to be reported by the investor as ordinary income during the applicable tax year.

Summary

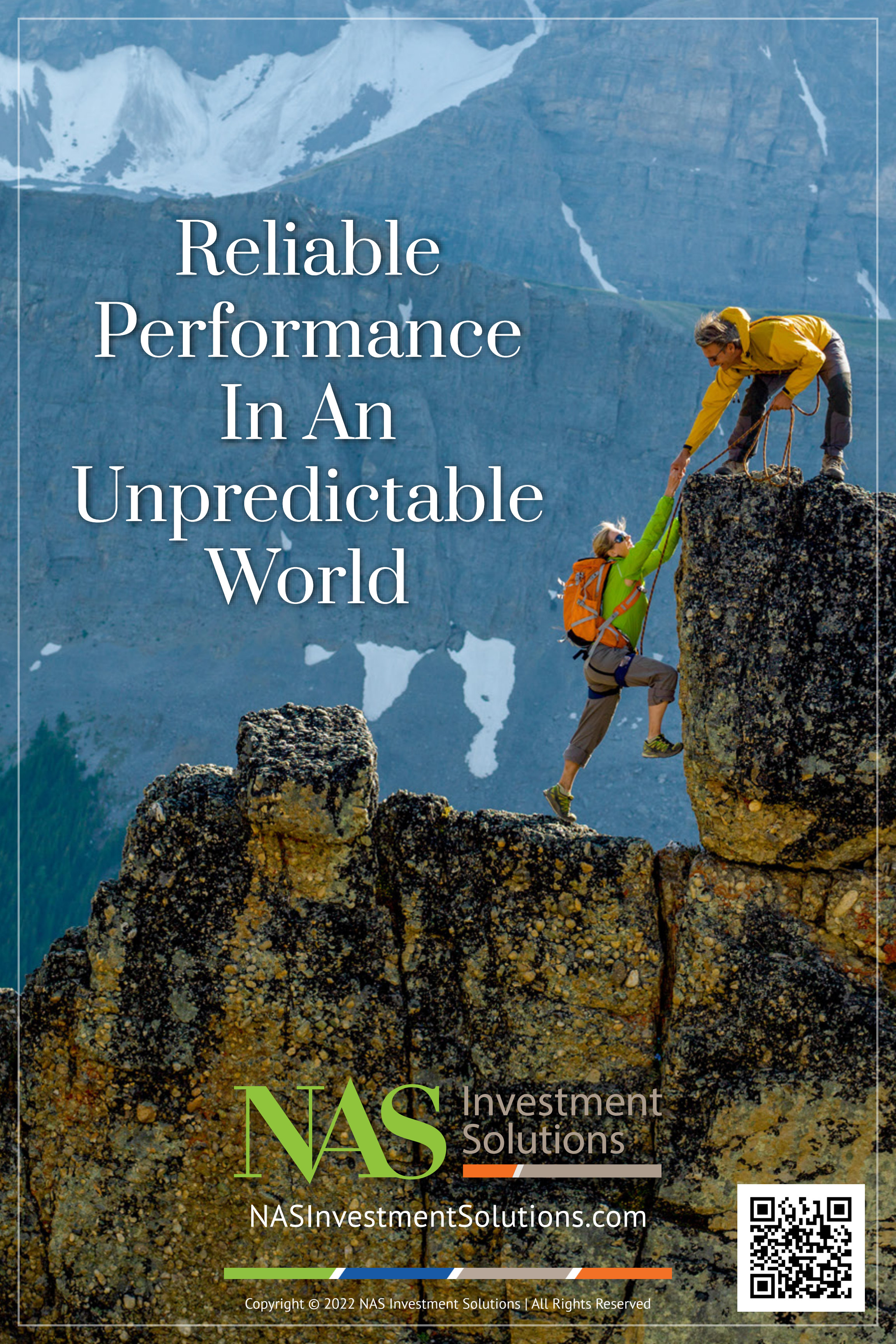
Section 1031 of the Internal Revenue Code helps business owners and investors save money on the sale of real estate. Sellers can relinquish one property, reinvest the capital gains in another property of equal or greater value, and defer paying capital gains tax.

1031 tax-deferred exchanges offer a profitable opportunity to owners of investment real estate. Taxpayers can build and preserve capital, generate cash from income-producing property, restructure and diversify portfolios, and gain better control over their productive real estate holdings.

There are seven criteria business owners and real estate investors must follow to qualify to defer the payment of all capital gains tax:

- Property must be like-kind real estate
- Real estate must be used for investment or business, and not be considered stock in trade or personal property
- Property replaced must be of equal or greater value to the property being sold
- Boot must not be received by the seller
- Title of the Sold Property and the Replacement Property must be in the same taxpayer name
- Replacement Property must be identified within 45 days of closing on the sale of the Sold Property
- Replacement Property must be purchased within 180 days of closing on the sale of the Sold Property

The process of conducting a tax-deferred 1031 exchange can be complex, but provided these specific criteria are followed, business owners and real estate investors can realize the many benefits and advantages of fully deferring the payment of capital gains tax.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