

Exchange Of Property Defers Payment Of Taxes

What is §1031 and what is a §1031 exchange? Section 1031 is a section of the United States Internal Revenue Code which allows a taxpayer to defer the tax otherwise payable on the gain resulting from the sale of investment or business property if he invests that gain in another piece of investment or business property of "like-kind" within a certain period of time. It is important to note that Section 1031 *defers* the payment of these taxes; it does not *exempt* the gain from taxation. This tax deferral is advantageous because it allows the taxpayer to invest extra cash in an appreciable asset.

Even though the tax code refers to an "exchange" of properties, typically taxpayers will not actually "trade" properties. The IRS allows the use of a "Qualified Intermediary" (also called the "QI," the independent third party who, for a fee, acts on behalf of the taxpayer as a facilitator of the exchange) to complete the transaction, as follows:

Step 1: Sell the Relinquished Property.

The taxpayer will enter into an Exchange Agreement with the QI setting forth certain terms and conditions and sign a contract to sell the Replacement Property, then assign the sale contract to the QI.

At closing, the deed may convey title directly from the taxpayer to the purchaser, but the QI should receive all proceeds and be shown as the "seller" on the settlement statement. All proceeds (including any good faith deposit) will be held by the QI until the closing of the purchase of the Replacement Property.

Step 2: Identify Replacement Property.

The taxpayer must identify the Replacement Property to be acquired and provide written notice of its choice(s) to the QI within 45 days after the sale of the Relinquished Property closes. The taxpayer may identify up to three potential Replacement Properties (or more, if certain value limits are met).

Step 3: Purchase Replacement Property.

The taxpayer will enter into a contract to buy the Replacement Property and assign the contract to the QI. The purchase of the Replacement Property must close within 180 days after the closing of the



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sale of the Relinquished Property.

At closing, the deed may convey title directly to the taxpayer, but the QI should be shown as the "buyer" on the settlement statement. If the purchase price is more than the proceeds from the sale of the Relinquished Property, the taxpayer must make up that difference, but if the purchase price is less and the taxpayer gets cash out of the closing as a result, then that will be counted as taxable income.

Reverse Exchanges and Other Variations

It is possible to reverse these steps and acquire the Replacement Property before the Relinquished Property is sold. It is also possible to use exchange funds to build a new facility if the time requirement is met and the transaction is structured properly.

The Newest Wave in Replacement Properties: Tenant-in-Common Interests

If a taxpayer can't find that perfect piece of replacement property here in the Shenandoah Valley, he might consider buying a tenant-in-common interest in an office building somewhere else, say in Manhattan or Dallas or any other real estate market! Increasingly, savvy real estate professionals and syndicators are putting together groups of up to 35 individuals to pool their resources (usually 1031 exchange proceeds) and purchase top-quality investment properties across the country as tenants-in-common. This expands investment opportunities and can make the process of identifying Replacement Properties much easier for some taxpayers.

This overview is greatly simplified and Section 1031 is full of traps for the unwary, so competent advice is crucial to ensure the right tax results.

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