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Valuable Information for Real Estate Professionals and their Clients

COMMERCIAL REAL ESTATE EXCHANGES

WHAT IS A §1031 EXCHANGE?

A §1031 tax deferred exchange is a method by which a taxpayer trades property, held for investment or business purposes, for replacement property resulting in deferral of capital gains tax on the transaction.

DO BOTH REAL AND PERSONAL PROPERTY QUALIFY?

In general, tax deferred exchanges fall into two types: real property and personal property. Real property must be exchanged for other real property and is not considered like-kind to personal property.

Personal property requirements are more restrictive than that of real property exchanges. To qualify for §1031 exchange treatment, personal property can only be exchanged for personal property that falls within the same Product Class or General Asset Class. For example, washing and dryer machines can be exchanged for other washing and dryer machines, but not for computers.

WHAT ABOUT GOODWILL OR "GOING CONCERN"?

Treas. Reg. §1.1031(a)-2(c)(2) states that "the goodwill or going concern value of a business is not of a like-kind to the goodwill or going concern value of another business." The reasoning is that due to the uniqueness of any single business, the goodwill could not possibly have the same nature. Therefore an exchange of "Jan's Coffee Shop" for "Bob's Coffee Shop" can only be comprised of real property and the equipment. The value allocated to goodwill for Jan's coffee shop would be excluded from §1031 exchange treatment.

ARE "BUSINESS SWAPS" STILL ALLOWED?

In 1957 the IRS issued Rev. Rul. 57-365 which stated that the exchange of identical business assets, including both real and personal property, of two telephone companies would be considered "property of like kind". In 1989, Rev. Rul. 89-121 clarified the "identical business asset" rule set forth in 1957. The ruling stated that the mere fact that multiple assets comprise a business or investment does not mean that they may be treated as disposing of a single property. Therefore, "business swaps" are no longer allowed. The current system requires all taxpayers engaging in a multiple asset exchange to group the properties, both real and personal, into like-kind or like-class groups. Treas. Reg. §1.1031(j)-1.

CONSIDERATIONS TO BE MADE

- ▶ Inventory property does not qualify for tax deferral under §1031. Therefore the capital gain or loss must be recognized by the Exchanger.
- ▶ Allocation of the value to like-class groups must be determined prior to the sale of the property.
- ▶ What entity holds title to the property? If it is a business entity, such as a partnership, then the same partnership must acquire the replacement property.
- ▶ If one or more of the partners wants out, contact our office as soon as possible. We may be able to work with your tax and legal counsel to determine whether a partnership dissolution or distribution may be a viable option for your transaction.