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Valuable Information for Real Estate Professionals and their Clients

TAX DEFERRED EXCHANGE REQUIREMENTS

WHAT IS A TAX DEFERRED EXCHANGE?

A tax deferred exchange is a method by which a taxpayer trades property, held for investment or business purposes, for replacement property which results in a deferral of tax on the transaction. The taxpayer should be aware of the requirements for tax deferral before making a decision to enter into a Section 1031 tax deferred exchange.

1. QUALIFIED PROPERTY REQUIREMENT

In general, all property or equipment held for investment purposes or used in a business or trade qualifies for exchange treatment. However, certain types of property are specifically excluded from Section 1031 treatment, namely:

- ▶ Property you use for personal purposes, such as your home or family car
- ▶ Stock in trade or other property held primarily for sale such as inventories, raw materials, and real estate held by dealers
- ▶ Stocks, bonds, notes or other securities or evidences of indebtedness
- ▶ Interests in a partnership or multi-member limited liability company

2. PURPOSE REQUIREMENT

Both the relinquished property and the replacement property must be held for productive use in a trade or business or for investment. Personal residences, as well as property acquired for immediate resale, do not qualify for 1031 exchange treatment.

3. LIKE KIND REQUIREMENT

Replacement property acquired in an exchange must be "like-kind" to the property being relinquished. Provided that real property is initially acquired and held for either business or investment purposes, it can qualify as a suitable replacement property under IRC Section 1031. Personal property that is relinquished must be either like-kind or like-class to the personal property which is acquired.

4. EXCHANGE REQUIREMENT

The relinquished property must be exchanged for other property, rather than sold for cash and using the proceeds to buy the replacement property. Most deferred exchanges are facilitated by Qualified Intermediaries, who assist the taxpayer in meeting the requirements of Section 1031.

5. VESTING REQUIREMENT

It is required that the entity involved in an exchange remain consistent throughout the exchange.

6. HOLDING PERIOD REQUIREMENT

There is no definitive holding period for property involved in a 1031 exchange transaction, with the exception of property that involves related parties. This area of the IRC code is gray and subject to interpretation. In one private letter ruling the IRS did state that a minimum two year holding period would be sufficient. However, when a taxpayer is seeking advice on this issue, we strongly recommend that they seek the counsel of their personal tax advisor.