MEGA 1031

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What every investor should know

In a typical transaction, you are taxed on any capital gain realized when the property is sold. However, under Section 1031 of the IRS code, that capital gain tax can be deferred until some future date if the property is exchanged for a “like-kind” property.

According to Section 1031,

> “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.”

The theory behind Section 1031 is that when you reinvest the sale proceeds into another property, the economic gain has not been realized in a way that generates funds to pay any tax. In other words, your investment is still the same, only the form has changed (e.g. vacant land exchanged for apartment building). Therefore, it would be unfair to force you to pay tax on a "paper" gain.

Advantages of 1031 Exchanges

1. You can increase your buying power since federal capital gains taxes are deferred, allowing you to leverage these savings by putting them into the new property you are purchasing. This additional equity reinvested in the new property will make your financing easier.

2. You can do exchange after exchange, each time pyramiding your savings. Additionally, if you choose to pass the property onto your heirs, the deferred tax liability is completely forgiven by the IRS upon your death resulting in a greater profit for your heirs when the property is eventually sold.

3. As the Exchanger you will have greater selling power since you do not have to inflate the sales price in order to recoup some of the capital gains that would normally accrue when selling an investment property. This will enable you to set a more flexible and possibly profitable price.

4. You can acquire replacement property with greater income potential, for instance by selling raw land and acquire income-producing property. You could also acquire a apartment building with additional units or another income producing property in a more profitable location.

5. You have the opportunity to consolidate several difficult-to-manage properties into one easy-to-manage large property or to relocate or expand a current business or investment.

Basic Requirements of 1031 Exchanges

1. Both properties must be “Like-Kind”.

Like-kind simply means real property and refers to the nature or character of the property not its grade or quality.

Like-kind is a very broad and liberal category where just about any type of investment or business use property would qualify.
Examples of like-kind properties:

- rental properties (single family homes, apartment buildings, triplexes, etc.),
- office buildings, shopping malls, almost any type businesses, airports, marinas, golf courses, etc with a lease of at least 30 years including options
- parking lots
- farms
- factories, retail stores,
- timeshares
- interest in a co-tenancy
- oil, gas and mineral interests
- timber and water rights

It is important to note that properties which are not considered as like kind include: stocks, bonds, notes, interest in a partnership, certificates of trust and personal property.

Properties can be located anywhere within the US with no restrictions relating to the exchange taking place in one or more states.

2. Both Properties must be held for investment or business use.

Both the relinquished property and replacement property must be for investment or business use and each must be held for a minimum of one to two years.

You cannot purchase a replacement property with the intent to sell immediately.

Qualified 1031 exchange properties cannot be used for personal use more than 14 days per year (or 10% of the actual number of days the property has been rented in any given year).

3. Exchanger must use a Qualified Intermediary.

One of the so called "safe harbors" in the 1031 Exchange regulations is the requirement to use Qualified Intermediary in the actual exchange process.

Both the sale of the property you sell and the purchase of the replacement property must flow through the Intermediary, usually by direct deeding to avoid duplicate transfer taxes.

The qualified Intermediary may not be the taxpayer or an agent of the taxpayer (realtor, attorney, tax advisor, banker, accountant, employee, etc.) or lineal descendant of the Exchanger.

4. Seller must use a Qualified Intermediary.

The qualified Escrow Agent may not be the taxpayer (seller) or an agent of the taxpayer (such as your realtor, attorney, banker, accountant or other employee, etc.) or an actual lineal descendant of the Seller.

The Seller should not have any type of access to the proceeds from the sale of the property.

The Seller is entitled to all earnings on the escrow funds, but these taxable funds must also be restricted in the same manner as the principal.

The Seller is entitled to obtain security for his funds while the 1031 transaction is in progress.

5. To gain the benefits of 1031 Exchange, the proper documentation must be used.