

1031 Tax Deferred Exchange: Dodging the Capital Gains Tax Demon

With the recent decline in the stock market, some savvy investors have turned their attention to the profitable real estate market. Many of them have discovered a powerful tax strategy, the Internal Revenue Code Section 1031 tax-deferred exchange.

Using a 1031 tax-deferred exchange, a property owner can trade income or investment property without paying any federal income taxes on the transaction, hence keeping substantially more of the profit from the sale. With the capital gains taxes deferred, he or she is able to reinvest all of the proceeds, including the amount that would have been paid out in capital gains taxes, allowing the earning power of the tax-deferred dollars to work for the property owner in a better investment.

In essence, a 1031 tax-deferred exchange can be considered to be an interest-free loan from the Internal Revenue Service. The tax on an exchange does not have to be paid until an investor actually sells the property for cash, and no interest is charged on the taxes that are deferred. Investors can continue to exchange properties as often and for as long as they wish, thus moving up to better investments and putting off the taxes for many years. The extra purchasing power generated by deferring the taxes will produce increased income and larger investment holdings. Finally, if the investment property is left in the taxpayer's estate, at death the capital gains taxes are wiped away forever.

Under Internal Revenue Code Section 1031, there is no gain or loss recognized on the exchange of property held for productive use either in a trade or business or for investment if the property is exchanged solely for similar property. A 1031 tax-deferred exchange allows the taxpayer to trade existing real estate and maximizes the proceeds from a sale that can be applied toward replacement property. However, to qualify under Section 1031, replacement property must be identified within 45 days from closing on the sale of the relinquished property, with closing within 180 days.

The most common exchange format, the delayed exchange, requires investors to work with an IRS approved middleman called a "qualified intermediary," who documents the exchange by preparing the necessary paperwork - the exchange agreements - holding proceeds on behalf of the exchanger and structuring the sale of the relinquished property and purchase of the replacement property.