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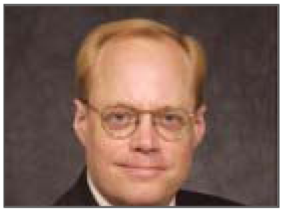

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7 Key Rules About 1031 Exchanges -- Before They're Repealed

A 1031 exchange, also called a *like-kind* exchange or a *Starker*, is a swap of one business or investment asset for another. Do it right, and there is no tax. You change the form of your investment without cashing out or paying tax. And like a 401(k), that allows it to continue to grow tax-deferred.

There's no limit on how many times you can do a 1031. You can roll over the gain from one piece of investment real estate to another, then another and another. You may have a profit on each swap, but you avoid tax until you actually sell for cash. But be careful and do it right.

La Grande – 1113 Adams (Photo credit: Wikipedia)

There's a proposal in Congress to repeal this storied provision. Although repeal is not likely in the short term, if you're considering a 1031 or are just curious, here are key rules you should know.

Investment, Not Personal. 1031 is for investment and business property, not personal. You can't swap your primary residence for another. But some exchanges of personal property (say a painting) can qualify. Can you convert your personal residence to "investment" and *then* do a 1031? Maybe. I'll cover this in a separate post soon.

Like-kind is Broad. "Like-kind" doesn't mean what you think it means. You can exchange an apartment building for raw land, a ranch for a strip mall. The rules are surprisingly liberal.

Delayed Exchanges are OK. Classically, an exchange is a simple swap of one property for another between two people. But the odds of finding someone with the exact property you want, who wants the exact property you have, are slim. For that reason, the vast majority of exchanges are delayed, three party, or "*Starker*" exchanges (named for the first tax case that allowed them).

In a delayed exchange, you need a middleman who holds the cash after you "sell" your property. The middleman, usually a qualified intermediary, then buys the replacement property for you using the escrowed cash. Subject to time limits below, this three-party exchange is treated as a swap.

Designating Replacement Property. There are two timing rules you must observe for a delayed exchange. Once the sale of your property closes, the intermediary receives the cash. Within 45 days, you must specify the property you want to acquire in writing to the intermediary. You can designate three properties so long as you eventually close on one of them. Alternatively, you can designate more properties if you come within certain valuation tests.

Close Within Six Months. Once you designate, you must close on the new property within 180 days of the sale of the old. Start counting when the sale of your property closes. The 45 days and 180 days run concurrently. Designate replacement property within 45 days, and you have 135 days left to close on the replacement property.

Cash is Taxed. If have cash left over, the intermediary pays it to you at the end of the 180 days. That cash is called "boot" and is taxed, generally as a capital gain.

Beware Mortgages. You must consider mortgage loans or other debt on the property you relinquish, and any debt on the replacement property you acquire. If you don't receive cash back but your liability goes down, that too will be treated as income just like cash.

You can reach me at Wood@WoodLLP.com. *This discussion is not intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.*