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Don't Foul Up Your 1031 Exchange

Even if you know no other tax code section, you likely know [Section 1031](#). It's the ubiquitous provision allowing swaps of one business or investment asset for another without tax. 1031 is bandied about by realtors, title companies, investors and soccer moms. Some people even make it a verb, a la [FedEx](#), as in: "Let's 1031 that building for another."

Although most swaps are [taxable as sales](#), if you come within 1031, you'll either have no tax or limited tax due at the time of the exchange. In effect, you can change the form of your investment without (as the IRS sees it) cashing out or recognizing a capital gain. Your investment continues to grow tax-deferred.

No Limit! There's no limit on how many times you can do a 1031. You can roll over the gain from one piece of investment property to another again and again. Although you may have a profit each time, you avoid tax until you actually sell for cash. Then you'll hopefully pay one long-term capital gain tax (currently 15%).

While you can make a simple swap of one property for another, the odds are slim you'll find someone with the exact property you want who wants the exact property you have. For that reason the vast majority of exchanges are delayed, three party, or "[Starker](#)" exchanges (named for the first tax case that allowed them). You need a middleman to hold the cash after you "sell" and to "buy" the replacement property for you. This three party exchange is treated as a swap.

Designate Within 45 Days. Once the sale of your property occurs, the intermediary will receive the cash. You can't receive the cash or it will spoil the 1031 treatment. Within 45 days of the sale of your property you must designate replacement property in writing to the intermediary, specifying the property you want to acquire.

Close Within 180 Days. Second, you must close on the new property within 180 days of the sale of the old. These two time periods run concurrently. You start counting when the sale of your property closes. If you designate replacement property exactly 45 days later, you'll have 135 days left to close on the replacement property.

Qualified Escrow. Another key rule is the qualified escrow account. Your money must remain there until you close the other leg of your exchange. The rules are not too complicated, and there's a whole industry of exchange accommodators out there. Still, use care and deal with reputable professionals.

A recent Tax Court case, [*Ralph E. Crandall, Jr. and Dene E. Dulin*](#), illustrates the mess these deals can become if you're not careful. Ralph Crandall and Dene Dulin owned investment property in Arizona but wanted investment property in California. Intending a tax-free exchange, they sold the Arizona property, directing the money into an escrow account with Capital Title.

They closed on the California property and reported it as a tax-free swap but the IRS cried foul. Why? None of the escrow agreements ***mentioned*** a like-kind exchange under 1031 or expressly limited their right to get the money. That disqualified the exchange even though they actually ***did use*** the money to swap for new property.

To be qualified, an escrow agreement must ***expressly*** limit the taxpayer's rights to receive, pledge, borrow or otherwise obtain the cash or its equivalent held in the account. The Capital Title escrow account wasn't qualified. So even though this couple reinvested their sales proceeds, they had to pay tax.

Beware Debt. Other common glitches involve debt on the old or new property. One of the main ways people get into trouble with these transactions is failing to consider loans.

For more, see:

[Ten Things To Know About 1031 Exchanges](#)

[Like-Kind Exchanges – Real Estate Tax Tips](#)

[Like-Kind Exchanges Under IRC Code Section 1031](#)

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