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## THE POWER OF EXCHANGE

Valuable Information for Real Estate Professionals and their Clients

# AN INTRODUCTION TO THE BENEFITS OF §1031 TAX DEFERRED EXCHANGES (PART II)

Exchangers have a number of ways to properly identify properties. They may identify up to three target properties without regard to their total fair market value (Three Property Rule). Alternatively, they can identify an unlimited number of replacement properties, if the total fair market value of all properties is not more than twice the value of the property sold (200% Rule). As a final option, an Exchanger can break both of these rules if they acquire 95% of the aggregate fair market value of all identified replacement properties.

**Requirement #3:** Close on the replacement property by the earliest of either: 180 calendar days after closing on the sale of the relinquished property or the due date for filing the tax return for the year in which the relinquished property was sold (unless an automatic filing-extension has been obtained).

Example: If an Exchanger closes on the relinquished property on December 27, the 180 day period will end after April 15 (Tax Day). In this case, they would have to close on the replacement property (or request an extension of time to file their taxes) by April 15. Exchangers may choose to close both transactions within a shorter period of time, thereby avoiding the potential hardship of the 45/180 day time limits.

**Requirement #4:** The most common exchange format, the delayed exchange, requires investors to work with an IRS-approved middleman called a "Qualified Intermediary." The Qualified Intermediary actually documents the exchange by preparing the necessary paperwork (Exchange Agreements), holding proceeds on behalf of the Exchanger, and structuring the sale of the relinquished property and purchase of the replacement property.

Note: To defer all capital gains taxes, an Exchanger must buy a property or properties of equal or greater value (net of closing costs), reinvesting all net proceeds from the sale of the relinquished property. Any funds not reinvested, or any reduction in debt liabilities not made up for with additional cash from the Exchanger, is considered "boot" and is taxable. Example: Stewart sells his duplex, which he held for investment, for \$160,000. A hundred days later he closes on a different duplex, which he will hold for investment, for \$110,000. Stewart banks the \$50,000 in excess funds for his child's education. Stewart must pay capital gain taxes on \$50,000. (In this example, Stewart chose to take some money out of his exchange and pay the tax.)

### WHEN ARE CAPITAL GAIN TAXES PAID?

Maybe never. Many investors mistakenly believe they will "have to pay the taxes sometime" so they might as well just sell. Quite often, this is a bad decision. The tax on an exchange is deferred into the future and is only recognized when an investor actually sells the property for cash instead of performing an exchange. 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.



**ASSET PRESERVATION, INC.**

A National IRC §1031 "Qualified Intermediary"

(800) 282-1031 [www.apiexchange.com](http://www.apiexchange.com)

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