

## What is a 1031 Tax-Deferred Exchange?

The 1031 tax-deferred exchange (as permitted by §1031 of the Internal Revenue Code) is a way for a property owner to exchange prior owned property for new property without incurring income tax on the gain - a tax deferred exchange. This transaction represents substantial savings for the property owner. Independent Trustees, Inc. can act as the Qualified Intermediary in these types of transactions.

The most common transaction is a delayed or deferred exchange: Under this scenario, Independent Trustees, Inc., holds the proceeds for the sale of the first property for the benefit of the client, until a second property is identified as replacement property. Proceeds from the sale of the first property are deposited into an interest bearing account, where the client receives interest on deposited funds at competitive rates of return. Independent Trustees, Inc. then forwards the proceeds (including interest) for the purchase of the replacement property, at the time of the second closing.

When an Exchanger is exchanging real property, "like-kind" is one of the advantages of §1031 exchanges. All real property is "like-kind" with all other real property. "Like-kind" refers to how the property is held by the investor, not the type or character of the property. The Exchanger must have held the relinquished property for investment or for the "productive use in their trade or business" and intend to do the same with the replacement property. The following are examples of "like-kind" property:

Residential for commercial

Bank building for swampland. Bare land for residential.

Fee simple interest for 30-year leasehold

Single-family rental for multi-family rental

Non-income producing for income producing

Rental mountain cabin for a dental office in which the exchanger intends to practice

The exchanger must hold the relinquished property for investment or for "productive use in their trade or business" to qualify for §1031 treatment. The critical issue here is the exchanger's purpose in holding the property-how he intends to use the property- rather than the type of property.

The following are examples of qualifying properties:

Bare Land

Commercial rental

Industrial property

30-year leasehold interest

Farmer's farm

Residential rental

Doctor's own office

Percentage interest in investment property

The intent to hold the property for personal use will prevent the property from qualifying from §1031 treatment. Therefore, second homes will not qualify for §1031 treatment unless the property owner changes how they treat or use the second home. For example, a taxpayer could "convert" their second home to a valid exchange property and establish this intent by properly renting the property and holding it as a legitimate rental property. Consultation with a tax advisor is important whenever a taxpayer changes how they intend to hold property.

The intent to hold property "primarily for sale" will prevent the property from qualifying for § 1031 treatment. Most properties owned by developers, builders and people who perform rehabilitation work are held primarily for sale and may not be the subject of an exchange. When these properties are sold, they are subject to ordinary income taxes rather than capital gain taxes.

Partnership interests, notes secured by real property, contract vendor's interests, and foreign property (under the Revenue Reconciliation Act of 1989) do not qualify for §1031 treatment.

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