

## **INTERNAL REVENUE CODE SECTION 1031 LIKE-KIND EXCHANGES**

### **GENERAL REQUIREMENTS**

**1031 Exchange** Sellers of investment property which has appreciated in value will realize capital gains taxes at the closing of the sale of their investment property. The current federal tax on capital gains is 15%. The South Carolina tax on capital gains is 7% for individuals, and 5% for corporations. For more information on South Carolina's capital gains and withholding requirements, please see our memorandum on South Carolina nonresident withholding taxes. Sellers of investment property may defer their capital gains tax liability by purchasing another investment property with the proceeds from the sale of the first investment property pursuant to Internal Revenue Code Section 1031. Such a transaction is frequently called a "tax deferred exchange" or a "1031 exchange."

**General Rules** There are certain Internal Revenue Code and Regulation rules that the taxpayer must follow for the 1031 exchange to qualify for capital gains tax deferment. First, the property must be investment property. Therefore, the taxpayer must have owned it at least one year. Gains on properties owned less than one year are generally taxed at income tax rates. Also, the properties must be "like-kind." Fortunately, nearly all real estate has been interpreted by the IRS as "like-kind", except foreign property. Next, the net proceeds from the sale of the "relinquished property" must be held by a "qualified intermediary" pending the taxpayer's purchase of a "replacement property".

**Qualified Intermediary** The qualified intermediary may not be affiliated with the taxpayer. In other words, the qualified intermediary may not be the taxpayer's banker, attorney, accountant, brother, spouse, etc. To effectively document a 1031 exchange, our firm drafts a Trust Agreement and an Exchange Agreement between the taxpayer and the qualified intermediary which conforms to IRC Section 1031 requirements. The agreements obligate the qualified intermediary to hold and disburse the taxpayer's sales proceeds from the relinquished property upon stipulated terms and conditions. We use Maria Belbas-Parker, Esquire, a Hilton Head Island attorney, as the qualified intermediary for our clients.

**Timing the 1031 Exchange** The taxpayer has 45 days following the closing of the sale of the relinquished property to identify the replacement property. If a particular replacement property is not identified within that 45 day period, then the taxpayer may identify alternative properties. In fact, the taxpayer may purchase up to three replacement properties. The taxpayer must close on the purchase of the identified replacement property within 180 days of the closing of the sale of the relinquished property. The funds for the purchase of the replacement property will be disbursed by the qualified intermediary directly to the settlement agent at closing of the purchase. Any additional funds for the purchase will need to come from the taxpayer, or the taxpayer's mortgage lender. The settlement statements for both the closing of the relinquished property and the closing of the replacement property need to reflect that the funds are channeled through the qualified intermediary.

**Reinvest All Relinquished Property Value** To defer all capital gains, the entire value of the relinquished property must be reinvested in the replacement property. Reinvesting the amount of

the taxpayer's gain, or just reinvesting the net proceeds of the sale of the relinquished property, into a replacement property may subject the taxpayer to capital gains taxation. If the value of the relinquished property is not completely reinvested in the replacement property, the amount that is not reinvested is subject to tax. That amount is frequently called "boot". On a related issue, at the closing of the replacement property, the taxpayer cannot "cash out" from a mortgage loan. Cashing out occurs when the mortgage loan on the replacement property combined with the funds from the qualified intermediary's account exceed the purchase price of the replacement property. Therefore, it is important not to augment your 1031 exchange proceeds with a mortgage loan which combine to exceed the cost of the replacement property.

**Title to the Property** Title to the relinquished property and the replacement property must be identical. Therefore, if title to the relinquished property is in the name of a corporation or limited liability company, that same entity must take title to the replacement property. It is important to note that property must be held for at least one year before it can qualify as investment property. If a taxpayer purchases property and sells that property inside of a year, the IRS will likely look at the gain regular income subject to income taxation, rather than capital gains tax. This is only a general summary of the issues involved in 1031 exchanges. For more information, please refer to IRS Tax Bulletins 554 and 551.