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Section 1031 back in vogue – But be careful - by Joe Mecagni ~ New England Real Estate Journal

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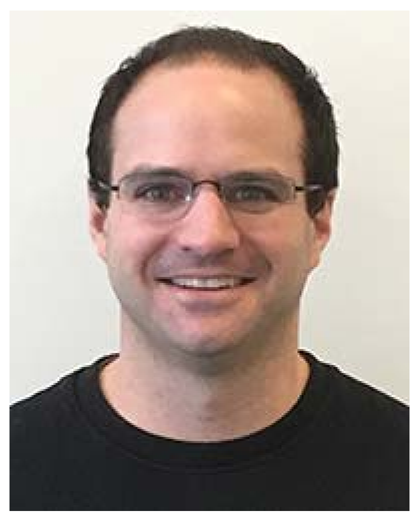

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Generally, taxpayers pay tax on property they sell at a gain. A tax-deferred exchange under Section 1031 offers a great opportunity to delay capital gains taxes and build wealth. However, if not done correctly, taxpayers may be subject to tax, interest and penalties at the time of transaction. Following are some of the pitfalls and traps for the unwary.

In a Section 1031 exchange, no gain or loss is recognized on the exchange of property held for productive use in a trade or business or for investment, if such property is exchanged solely for property of like kind which is to be held either for productive use in a trade or business or for investment.

To qualify for a like -kind exchange, properties must be like-kind and held for use in a trade or business, or for investment. Like-kind property must be of the same character, nature or class. Property such as a primary residence, second home, vacation home, or a property used primarily for personal use does not qualify for like-kind exchange treatment. The following types of property are excluded from a 1031 exchange:

- Inventory or stock in trade;
- Stocks, bonds, or notes;
- Other securities or debt;
- Partnership interests; and
- Certificates of trust.

Most real estate property will be like-kind to other real estate. For example, exchanging a commercial building for undeveloped land will qualify. However, if in an exchange a seller receives cash, relief from debt, or other property that is not like-kind, a taxable gain may result.

A qualified intermediary is often used to facilitate the exchange of properties and will hold any proceeds until the transaction is complete. It is important to select a reputable intermediary with a track record of integrity. Be wary of individuals who promote improper use of a like-kind exchange or encourage the use of non-qualifying property in an exchange.

Two deadlines must be met to qualify for a like-kind exchange. The first deadline is activated on the date the relinquished property is transferred, called the identification period. Taxpayers have 45 days to identify the replacement property. The identification must be in writing and must properly describe the property, street address or distinguishable name. Generally, taxpayers identify three potential exchange properties; however, any number of properties may be identified if special rules and exceptions are met.

The second deadline is the exchange deadline. The exchange must be completed no later than 180 days after the transfer of the exchanged property or the due date of the income tax return including extensions for the tax year in which the relinquished property was sold, whichever is earlier. Be mindful of this deadline, as there is no leeway if a mistake is made.

Refinancing to pull equity out of a property before and after an exchange can result in a taxable transaction if not done carefully. The step transaction doctrine could enable the IRS to recharactarize the two transactions into a single transaction if it appears the taxpayer's intent was to withdraw equity and avoid gain recognition.

Exchange of properties held in a partnership require special planning. Partnership interests are excluded from non-recognition treatment; however, the partnership may exchange property in a qualified exchange. Problems can arise when individual partners in the partnership have different investment objectives. One or more partners may wish to withdraw from the partnership and receive cash or other property for their partnership interest, while others may want exchange treatment. Be careful and plan accordingly if any partners desire to withdraw and liquidate prior to the exchange in order to avoid a taxable transaction.

Taxpayers also need to consider state income tax issues. Many states follow the federal 1031 exchange rules. However, some states do not recognize 1031 exchanges. In these states, taxpayers could successfully defer federal tax and owe state tax on the same transaction. Many states require mandatory non-resident tax withholding that must be paid when property is transferred to a buyer. Some states require exchanging properties in the same state or have their own special reporting procedures. Be careful of the state tax issues when planning an exchange.

A properly executed like-kind exchange remains a very powerful planning technique. The like-kind exchange rules are complex and must be carefully reviewed with your trusted tax advisor.

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