



Trading Properties

Defer Capital Gains Taxes

By Nathan Scharton and Michael Anderson

Many owners of investment and business properties are not aware of the opportunity to save a great deal of money in capital gains taxes by exchanging, rather than selling, appreciated investment property. A “like-kind exchange” or “1031 exchange” under Section 1031 of the Internal Revenue Code provides that the federal capital gains taxes that ordinarily accrue upon the sale of appreciated property are deferred when business or investment real estate or personal property is exchanged rather than sold.

A 1031 exchange allows a property owner to defer capital gains taxes on the sale of appreciated investment property, if the owner reinvests the proceeds of the sale in like-kind property within certain time frames and guidelines. For example, if a piece of real property held as an investment was purchased for \$20,000 in 2001, and sold for \$100,000 in 2008, ordinarily the \$80,000 gain would be taxed at capital gains rates. However, if the taxpayer exchanges the investment property for



another investment property, the capital gains tax on the \$80,000 gain is deferred.

“Like-kind” refers to the types of properties that can be exchanged. In the context of real estate, a property owner can exchange property held for investment into other property held for investment. As a general rule, property held for personal use cannot be exchanged under Section 1031. However, incidental personal use of property does not necessarily disqualify property from a 1031 exchange, so careful consultation with a tax adviser or attorney is important. Participating in a 1031 exchange requires some planning prior to the sale of the appreciated property. At a minimum, a contract for the sale of appreciated property should contemplate the possibility of a 1031 exchange (although the absence of a 1031 exchange provision is not necessarily fatal to the process).

There are some requirements of co-operation imposed on a buyer of property that is the subject of a 1031 exchange,

so a seller should include language in the contract to sell the appreciated property that requires the buyer to cooperate in signing the appropriate paperwork to facilitate the exchange. The 1031 exchange process also involves the participation of a qualified intermediary (such as Zions Bank Exchange Services), which acts as a middleman and facilitates a three-way trade or exchange of properties and funds.

Under Section 1031, a property owner cannot receive or hold the cash from the sale of the property being sold (the relinquished property). The intermediary must hold the proceeds of the sale of the relinquished property until the taxpayer closes on the purchase of a replacement property. The intermediary holds the funds and provides the paperwork to properly facilitate the exchange.

The sale of the relinquished property and the purchase of the replacement property can occur all at once or over a series of closings. A simultaneous exchange occurs when the entire trade is done in one closing. A common method of exchanging property is through a delayed exchange, where the seller of the relinquished property first completes the sale of that property and later closes on a replacement property. A delayed exchange is convenient because a seller can close on the sale of the relinquished property, and following that closing, spend time identifying a good replacement property or properties. The general guidelines for a delayed exchange require that the seller of the relinquished property identify the replacement property within 45 days of the transfer of the relinquished property, and close on the replacement property within 180 days of the closing of the relinquished property.

From time to time a party engaging in a 1031 exchange will need to close on the replacement property prior to the sale of the relinquished property, which is referred to as a “reverse exchange” and can be facilitated by a 1031 intermediary. These reverse exchanges are more complicated and technically challenging, and as a result, more expensive than “forward” exchanges.

A seller exchanging appreciated property under Section 1031 can identify up to three potential replacement properties, and can close on one, two or all three

of those properties as long as the other 1031 guidelines are met. Alternative rules regarding the identification of replacement properties may allow greater numbers of properties to be identified.

While the underlying concept is simple, the execution of an exchange can be very complex and requires the assistance of competent professionals. Failure to carefully address the formal requirements of Section 1031 can result in the IRS rejecting the transaction as a tax-deferred exchange, with potentially disastrous tax consequences to a taxpayer.

It is also important to remember that an exchange under Section 1031 is tax-deferred, not tax-free. If the replacement property is ever sold, the deferred gain, plus any additional gain realized since the purchase of the replacement property, is subject to tax.

Zions Bank Exchange Services, under the direction of Michael Anderson, is an excellent resource for all types of 1031 exchange issues and can be reached at 877-596-1031. The exchange intermediary, along with the taxpayer’s attorney and accountant, forms an invaluable team to help a taxpayer navigate the 1031 exchange process.²⁶

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