The Steps to a Successful 1031 Exchange

While many of our clients' 1031 exchanges are complex, every 1031 exchange requires adherence to basic rules and guidelines. The following outlines the basic steps of a 1031 Exchange..

Prior to Closing of the Relinquished Property

IRS Regulations require that the exchange documentation be in place prior to the closing on the property being relinquished or disposed of. Once you determine that you should structure your transaction as a 1031 Exchange, the next step is to add an Addendum to the contract for the sale of the property. This Addendum, while technically not required, is suggested in order to show the intent to do an exchange, permit assignment of the contract to the Qualified Intermediary (QI), and to reassure the buyer that there is no additional expense or liability for the buyer.

Relinquished Property Addendum

Once the contract on the property being relinquished has been ratified, a copy of the contract should be provided to the Qualified Intermediary (or "QI"), along with the contact information of the attorney, and the title company, settlement agent, or escrow agent who will be conducting the closing.

The QI then prepares the required Exchange Agreement, the Assignment, and the Notice of Assignment, and provides this document package to the taxpayer and counsel, and provides instructions to the settlement agent. These documents must be signed and delivered prior to the closing (or the very latest, at the closing).

After Closing

The settlement agent should wire the funds directly to the QI, and forward copies of the settlement statement and other closing documents to the QI, either electronically or by overnight delivery.

45-Day Identification

Within 45 days of the transfer of the first relinquished property, the taxpayer must provide an identification of the potential replacement property/properties to the QI. The Regulations provide different identification options: (i) if the replacement property is received before the end of the 45-day identification period, it is considered identified; (ii) identify no more than three alternative properties, regardless of fair market value; (iii) if the taxpayer identifies more than three properties, the total fair market value should not exceed 200% of the value of the property relinquished; (iv) if identifying more than three properties, with total fair market value exceeding 200%, then the taxpayer must actually acquire a minimum of 95% of the identified fair market value. A more detailed discussion of the identification requirements is contained in this post.

IRS Regulations require the identification of replacement properties be in writing, be signed by the taxpayer, and delivered to the QI. Properties should be identified by street address and/or legal description, or other readily identifiable means, such as "the Mayfair Apartment Building, Collingswood, NJ."

After the 45-day period has expired, only those properties that were properly identified may be acquired as replacement properties and be part of the exchange. No new properties may be identified after the 45-day identification period.

The identification may be revoked or amended at any time during the 45-day identification period and new replacement property may be identified. However, this also must be done in writing, be signed by the taxpayer, and be delivered to the QI before the end of the identification period.

Identification of Property to Be Built

The regulations provide special rules for the identification and receipt of replacement property to be built. The identification requirement for the property to be built will be met if the identification provides "a legal description for the underlying land and as much detail is provided regarding construction of the improvements as is practicable at the time the identification is made." Note: Improvements to be made to property already owned by the taxpayer are not considered like-kind and cannot be used as a replacement property in a 1031 exchange.

180-Day Exchange Period

The taxpayer must complete the acquisition of the identified property/properties within 180 days from the transfer of the first relinquished property – or the due date of their tax return, whichever date is earlier. Taxpayers who start their 1031 exchanges after October 15 may want to consider filing for an extension on their income taxes in order to obtain the benefit of the full 180-day exchange period. Obtaining an extension requires filing IRS Form 4868, and provides an extension on the due date of the tax return only, not on the 180-day exchange period.

Prior to Transfer of the Replacement Property

When an offer is made on a desired replacement property, an Addendum may be added, stating that the transaction is part of a like-kind exchange, that the contract may be assigned to the QI, and that there is no additional liability or expense to the sellers. As with the addendum for the relinquished property, this is technically not required to comply with Section 1031.

Replacement Property Addendum

Once the QI receives a copy of the contract to purchase the replacement property, the QI will prepare the appropriate Assignment of Contract, Notice of Assignment, and instructions to the settlement agent. The QI will coordinate with the taxpayer, taxpayer's counsel, and the settlement agent, and wire the exchange funds to the settlement agent.

Reporting the Exchange - IRS Form 8824

As part of the tax return for the year that the relinquished property was transferred, the taxpayer will report the exchange on IRS Form 8824, Like-Kind Exchange.