

## WHAT IS A TAX FREE EXCHANGE?

Section 1031 of the Internal Revenue Code also known as a 1031 Exchange or a tax-free exchange is a legal, investment process by which a property owner can avoid paying capital gain taxes. Capital gain taxes are normally paid when a property owner realizes a profit on the sale of a property. These taxes can be very costly to a seller, especially when the seller has little or no basis in the property being sold.

These exchanges are set up to allow a seller of real property to purchase another real property with their sale proceeds and avoid paying capital gain taxes. Often these exchanges are said to be like-kind exchanges, but this can be confusing. A duplex can be exchanged for a tract of undeveloped land, an office building can be exchanged for a motel. However, real property cannot be exchanged for personal property.

These exchanges can be ideal to defer capital gain taxes. At times you see someone sell a non-productive property and exchange it for an income producing property. An example of this would be someone selling undeveloped land that can create a property tax burden and exchange it for a commercial or residential rental property. This allows a property owner to convert an annual expense into an income stream, which is what I like to call “mailbox money” – rental payments being mailed to you monthly.

As you can imagine in dealing with the Internal Revenue Service, there are certain guidelines that must be followed to take advantage of this investment strategy. There must be a designated qualified intermediary (QI) to assist with the transaction. Many attorneys are capable of serving as a QI. This person is required to handle the documentation and to hold the proceeds from one closing and apply them to the second closing. A seller is not allowed to take possession of the closing money; and if he does the exchange is not allowed.

Another essential provision is that a seller must identify properties that he is considering for the exchange within 45 days of the sale of his property and must close on the replacement property within 180 days after the closing of the property that was sold.

The tax free exchange is not terribly complicated, but must be structured properly to benefit the seller. I would recommend that if this type of exchange interest you, that you contact a tax advisor, attorney or real estate agent for further details.

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