

1031 Exchanges

Internal Revenue Code Section 1031 is a powerful tool for deferring capital gains tax on commercial/investment transactions. It allows taxpayers to exchange real or personal property for new “like-kind” property, while deferring recognition of any capital gains. In order to accomplish a tax-free “exchange” there must be an exchange of properties. In 1984, Congress enacted legislation to allow deferred exchanges, meaning that an investor could sell property to an unrelated buyer, after having entered into an exchange agreement with a qualified intermediary, and then identify any like kind property within certain timeframes.

A taxpayer desiring to do a 1031 Exchange lists and/or markets his property for sale in the normal manner without regard to the contemplated 1031 Exchange. A buyer is found and a Purchase & Sale Agreement to sell the property is executed. Accommodation language is usually placed in the contract securing the cooperation of the buyer to the seller’s intended 1031 Exchange. When contingencies are satisfied and the contract is scheduled for a closing, the services of an Intermediary are arranged for. The taxpayer enters into an Exchange Agreement with the Intermediary, which permits the Intermediary to become the “substitute seller” in accordance with the requirements of the Code and Regulations.

The Exchange Agreement usually provides for:

- An assignment of seller’s Purchase & Sale Agreement to the Intermediary.
- A closing where the Intermediary receives the proceeds due the seller at closing. Direct deeding is used. The Exchange Agreement will comply with the requirements of the Code and Regulations wherein the taxpayer can have no rights to the funds being held by the Intermediary until the exchange is completed or the Exchange Agreements terminates. The taxpayer “cannot touch” the funds.
- An interval of time where the seller proceeds to locate suitable replacement property and enter into a Purchase & Sale Agreement for that property. The interval of time is subject to the 45-Day and 180-Day rules.
- An assignment of the contract to purchase replacement property to the Intermediary.
- A closing where the Intermediary uses the exchange funds in his possession to acquire the replacement property for the seller.
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