ATLAS
1031 EXCHANGE

Qualifying Questions of a 1031 Exchange

There are many requirements to satisfy whether a 1031 exchange makes sense. The intent of this document is to reduce the maze to three questions. If the answer is yes to each, then additional time is justified to confirm the outcome with your accountant or CPA.

1. **Real Property**. To start, it is important to understand that in a 1031 exchange, a property is sold and acquired for equal or greater value (debt and equity) of the old property within 180 calendar days of the closing on the old property. Implying that you already need to own real property. If you don't you can continue reading to prepare for when you do, but a 1031 exchange is not applicable today.

   Partial exchanges are possible when the desire is to cash out some equity, though the first dollar out is taxable. This is known as equity boot. If the debt retired on the old property is not replaced in the replacement property, the Internal Revenue Service will consider this a benefit and impose a tax known as mortgage boot.

   Do you own any of the following partial list? If so, continue to question number two. Any type of real property held for investment or business use is eligible for a 1031 exchange. Real property is exchanged for any real property.

   - ➔ Land
   - ➔ Commercial Property
   - ➔ Rental or vacation property
   - ➔ Ranch or farm
   - ➔ Timberland
   - ➔ Oil, gas or water interest

2. **Held for Investment or Business Use?** 1031 exchanges are allowed on real property held for investment or for use in a business. In another words, the partial list above cannot be used predominantly for personal use. For example, a rental or vacation property cannot be used more than fourteen overnights per year for personal use. Otherwise, the property begins to look to the Internal Revenue Service as a second home.

   What is **not** eligible for 1031 consideration includes

   - ➔ Personal residence
   - ➔ Stock, bonds, notes
   - ➔ Inventory
   - ➔ Debts
   - ➔ Partnership interests

   A common question is what the hold time is required to qualify for a 1031. Though the

Internal Revenue Code does not state a hold time, it is suggested a minimum one-year hold is adequate to demonstrate the proper intent to hold the property for investment, unlike stock or inventory that is held for sale.

Revenue Procedure 2008-16 requires that vacation properties and dwelling units are held for two years as a rental and the replacement property must also be held for two years. In each year, the property must be rented a minimum of fourteen overnights to non-family members with personal use restricted to no more than fourteen overnights in each of the two years.

3. **Is there a capital gains or recaptured depreciation tax?** When real property is sold, a capital gain or recaptured depreciation tax is triggered. After all, one of the reasons to initiate a 1031 exchange is to defer the tax. Deferring the gain does not mean the tax obligation goes away it is simply postponed until the replacement property is sold.

The replacement property could be passed on to beneficiaries at death. The beneficiaries receive the property at a stepped-up basis. Meaning if they sold the property soon after receipt, they would not pay a tax. If they held it for a season, they would pay a tax between a comparable (or a comparable property priced when received) and the price sold given the property has appreciated in value.

If there is no capital gain or recaptured depreciation, there is potentially little reason to initiate a 1031 exchange. Either one of the other or both are typically present. However, there are additional reasons to consider a 1031 exchange that are outlined in a free eBook on 10 Reasons Why a 1031 Exchange Makes Sense available on the Atlas 1031 website. One reason is you may be relocating and want to be near your investment property. Another reason is to exchange to own a property that creates cash flow such as selling land for a rental property.

Here are three steps to determine the estimated tax triggered upon sale.

(a) The original purchase price plus the capital improvements less the depreciation taken equals the adjusted basis.

(b) The sales prices less the adjusted basis less the selling expenses such as a realtor's sales commission, title and recording fees equals the realized gain.

(c) The taxes are determined by first multiplying the depreciation taken by 25%. The balance of the realized gain less the depreciation is the amount that is taxed by federal and state capital gains rates.

Conclusion

The basic principles justifying a 1031 exchange have been outlined. If you have answered yes to each, then continuing your review is well worth your time. Atlas 1031 would be pleased to review your transaction and help determine the value of your 1031 exchange or the time use of money of the taxes that would otherwise to paid.

About the Author

Andy Gustafson, Certified Exchange Specialist®, serves as the managing member of Atlas 1031 Exchange, LLC, a worldwide accommodator of Internal Revenue Code Section 1031. To date, he has accommodated over 1,400 real and personal, simple and complex, domestic and international 1031 exchanges. You can reach him at 800.227.1031 and info@atlas1031.com.