

## 1031 Exchange Myths

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For close to two decades our firm, Realty Exchange Corporation, has been involved with IRS Internal Revenue Code Section 1031 and like-kind exchanges on a daily basis. During this time we have been involved with educating folks on how to do a like-kind exchange in accordance with the current law and guidance. Over the years we have heard and been questioned about many exchange myths, and lately we have had new myths spring up -- thus, the reason we selected exchange myths as the topic for the article in this edition.

### **Myths that have arisen recently:**

**Myth #1:** You must keep your replacement property as a rental for two years.

**Answer:** This myth is being promoted primarily by some real estate authors. It is based on the "safe harbor" provisions in Revenue Procedure 2008-16. In the Summer 2008 edition of this paper, we covered the new revenue procedure in detail. The IRC Section 1031(a)(1) requires only that the replacement property be held for productive use in a trade or business or for investment. The IRS has established no set number of months for a sale, exchange or conversion once the replacement property is properly held. If you receive an offer you cannot refuse, the properly held replacement property may be sold and exchanged again. Can the IRS agent question your exchange? Yes, the same as he can with any transaction. If you hold the property properly for two years and meet all the other requirements of the Revenue Procedure, then you will qualify for the "safe harbor," and the IRS will not question your exchange. Ascertaining that you have a "safe harbor" should not drive your investment and exchange decisions.

**Myth #2:** If you receive a property in a like-kind exchange, you must live in the property for five years before you claim the principal residence exclusion of capital gain set forth in IRC Section 121.

**Answer:** There was a legislative change to Internal Revenue Code Section 121 which states you must OWN the replacement property for five years before you may claim the exclusion. However, after living in the property as your principal residence for any two years of the past five years of ownership, you may claim the Section 121 \$250,000 or \$500,000 exclusion of gain upon sale of the property.

## Older Myths:

**Myth #3:** Only commercial properties are exchanged.

**Answer:** In fact, we estimate that there are ten residential or undeveloped lands exchanged for every commercial property. While the commercial properties, due to the dollars involved, get all the publicity, there is no IRS restriction on the exchange of other business or rental property.

**Myth #4:** Your exchange qualifies only if you buy a more expensive replacement property.

**Answer:** While you must buy as a replacement property an equal or more expensive property to defer all the gain, there is no regulation that your replacement property be of lesser value. If you buy down you will most likely have “boot,” which will be taxable. The entire gain will not be taxable, just the boot will be taxable.

**Myth #5:** Your accountant, attorney or your real estate broker may act as your qualified intermediary (QI).

**Answer:** To avoid such an arrangement the IRS regulations [IRS section 1.1031(k)-1(k)(1)] establish specific parties as being ineligible to act as the QI. We encourage all exchangers to be certain their QI is eligible.

**Myth #6:** Tax-deferred exchanges are not legal.

**Answer:** One of the first calls we ever received was from a party who was told anything this good had to be illegal. Of course, we referred them to the IRS regulations. Now, thanks to Inspector General prodding, IRS Fact Sheet 2008-18 on like-kind exchanges is readily available at [www.IRS.gov](http://www.IRS.gov) and explains how to do an exchange legally.

**Myth #7:** To complete an exchange the settlement agent may simply be asked to hold the funds.

**Answer:** While the settlement agent will be happy to hold the funds, there will be no exchange and no escrow agreement or assignment of contracts. No funds will be transferred to a QI and will remain constructively available to the taxpayer, which violates the rules of an exchange. You must comply with the IRS regulations and employ a QI to hold the funds and complete the required paperwork.

**Myth #8:** To do an exchange you must want the other person’s property.

**Answer:** This myth is a carry-over from many years ago. Thanks to the Starker court decision, only a few exchanges involve the direct exchange of properties. Today almost all exchanges involve the purchase of the replacement property from a totally new third party.

**Myth #9:** The property received must be the same type as the property given up. In other words if you sell vacant land, you must purchase vacant land. This is considered similar property.

**Answer:** In real estate the definition for like-kind is very broad, and any kind of real estate can be exchanged for any other kind of real estate. All exchange properties must be held for

productive use in a trade or business or for investment. For example, vacant land may be exchanged for a warehouse; a residential rental may be exchanged for a 30-year lease.

### **No Longer Prevalent Myths:**

**Myth #10:** The third party seller and the buyer need to write a contract on the property the exchanger desires.

**Answer:** In an exchange there is no requirement for either the third party buyer or seller to write any additional contracts. Most property owners balked at the requirement they write additional contracts and assume increased liability.

**Myth#11:** The last myth is that an exchange must be done simultaneously. That is, the title for relinquished property must transfer the same day as the replacement property.

**Answer:** Since the Starker court decision in 1979 and the 1984 changes to IRC 1031, this simultaneous transfer has not been required. In the Starker case there was almost a five-year delay. However, it now is written into the 1031 regulations that an exchanger must identify the replacement property within 45 days after settlement, and the new replacement property must be received within 180 days of the settlement of the first relinquished property. These periods may be extended in declared disaster areas or if an exchanger is in a combat zone.

While there are other exchange myths, the above covers those you will most likely encounter. The important thing is to call an exchange expert and get accurate and current information. Sign up for our free quarterly e-mail newsletter and tax alerts at [www.1031.us/signup](http://www.1031.us/signup).