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Why flip real estate when you can exchange it

Synopsis - Those who own real estate for investment purposes may focus on flipping it when an adequate gain has been reached. But there's another option: exchanging it under Section 1031 of the Internal Revenue Code. This article explains how such "like-kind" exchanges work, warning also of the complex rules and potential risks.

Full Article - There's no shortage of television shows addressing real estate these days. Many of these programs emphasize "flipping" properties when an adequate gain has been reached. But, if you're ready to move one of your investments, you might prefer to *exchange* it rather than flip it.

Reviewing the concept

Section 1031 of the Internal Revenue Code allows you to defer gains on real or personal property used in a business or held for investment if, instead of selling it, you exchange it solely for property of a "like kind." In fact, these arrangements are often referred to as "like-kind exchanges." The tax benefit of an exchange is that you defer tax and, thereby, have use of the tax savings until you sell the replacement property.

Personal property must be of the same asset or product class. But virtually any type of real estate will qualify as long as it's business or investment property.

Executing the deal

Although an exchange may sound quick and easy, it's relatively rare for two investors to simply swap properties. You'll likely have to execute a "deferred" exchange, in which you engage a qualified intermediary (QI) for assistance.

When you sell your property (the relinquished property), the net proceeds go directly to the QI, who then uses them to buy replacement property. To qualify for tax-deferred exchange treatment, you generally must identify replacement property within 45 days after you transfer the relinquished property and complete the purchase within 180 days after the initial transfer.

An alternate approach is a "reverse" exchange. Here, an exchange accommodation titleholder (EAT) acquires title to the replacement property before you sell the relinquished property. You can defer capital gains by identifying one or more properties to exchange within 45 days after the EAT receives the replacement property and, typically, completing the transaction within 180 days.

Proceeding carefully

The rules for like-kind exchanges are complex, so these arrangements present many risks. If, say, you exchange the wrong kind of property or acquire cash or other non-like-kind property in a deal, you may still end up incurring a sizable tax hit. Be sure to call us when exploring an IRC Section 1031 exchange and particularly before executing any documents.