

1031 EXCHANGES

Under Internal Revenue Code Section 1031, taxpayers of investment property or property used in a trade or business are allowed to defer capital gains taxes by rolling the proceeds from the sale of their relinquished property into another investment or property used in a trade or business of equal or greater value. Though the premise is simple, many taxpayers do not successfully complete these tax-deferred exchanges because they do not know how to navigate the complexity of the timing requirements set forth by the IRS or they get confused by ambiguities in the law.

In determining whether a tax-deferred exchange qualifies for favorable tax treatment under 1031, the taxpayer must (in almost all cases) sell the relinquished property prior to his purchase of the replacement property. The taxpayer has, from the date of the "transfer" or sale of the relinquished property, only 45 days to identify his replacement property, and only a total of 180 days from the transfer date to close on the purchase of the replacement property. These deadlines are fixed, are not extended by weekends or holidays, and cannot be extended due to a change in the taxpayer's circumstances. As a result, taxpayers often feel pressured to rush to close the transaction, or are placed in a poor bargaining position in order to satisfy these artificial deadlines.

When is Property Transferred?

To satisfy the IRS's requirements for tax-deferred exchanges, it is important to properly determine the date of sale or transfer of the relinquished property, and the receipt date of the purchased replacement property. Therefore, I always advise clients carefully to ensure that the effective date of the transfer is deemed to be a date that permits the taxpayer to complete the transaction within the required time periods for qualifying the 1031 transaction.

The Federal courts have determined that ownership of real property for Federal income tax purposes happens when the transfer of the "benefits and burdens" have occurred. There are a number of questions that are used to determine the transfer of these "benefits and burdens." The most important questions that the IRS will ask are:

- How did the parties treat the transaction?
- Was equity acquired in the property?
- Did legal title pass?
- Did possession of the property pass to the purchaser?
- Does the seller have an obligation to sell and conversely, does the purchaser have an obligation to make payments?
- Who is responsible for paying the real property taxes?
- Who receives the profits from the operation of the property?
- Who bears the risk of loss or damage to the property?

How to Delay the Deadlines?

Some taxpayers try to delay the transfer date in order to extend their deadlines for identification and purchase of replacement properties. Should the taxpayer/purchaser try to "extend" the deadline to identify and close on the replacement property, most sellers will want assurances that the taxpayer will, in fact, complete its "purchase" of the replacement property.

One method that taxpayers may use to delay the closing date of a 1031 exchange is leasing the property until the transaction can be finalized in accordance with the rules of 1031. For instance, the taxpayer (acting as the landlord) may allow the purchaser to lease the relinquished property until the taxpayer is able to find an appropriate property that can be used for the replacement property.

Alternatively, the taxpayer (acting as the tenant) could lease the replacement property from the seller until the taxpayer can obtain a buyer for the property he or she is selling (i.e. the replacement property).

It is not as easy as it sounds. If there is any way to summarize these thoughts in a few words, it would be "taxpayer beware". There is too much money at stake to allow an oversight that would prevent you from reaping the tax deferral benefits of a 1031 exchange. As such, it is highly recommended that you seek professional advices or retain counsel from an expert that is experienced in the matters of timing strategies for 1031 exchanges.

For more information, please contact Winnes Wong, C.P.A. at **626-299-3722** or email to **winnes@wongcpa.com** for any comments or inquiries. We welcome readers for any tax or accounting-related questions and reply you in the next publications.

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