

Understanding the 1031 Exchange Closing Process



1031 EXCHANGES - AN OVERVIEW

1031 exchanges provide investors with one of the best tax strategies for preserving the value of an investment portfolio.

By using an exchange, the investor can defer the recognition of capital gain taxes that would otherwise be incurred on the sale of investment property. The investor can then use the entire amount of the equity to purchase substantially more replacement property. To qualify as an exchange, the relinquished and replacement properties must be qualified "like-kind" properties, and the transaction must be structured as an exchange.

THE EXCHANGE PROCESS

An exchange is rarely a swap of properties between two parties. Most exchanges, whether they are simultaneous or delayed, involve three parties: the investor (exchanger) who is doing the exchange, the buyer who is purchasing the exchanger's old (relinquished) property, and the seller who is selling the exchanger a new (replacement) property.

To create the exchange of assets and to obtain the benefit of the "Safe Harbor" protections of the tax code to prevent actual or constructive receipt of the exchange proceeds, which would disqualify the exchange treatment, prudent exchangers use the services of a "Qualified Intermediary (QI)." The Qualified Intermediary becomes a fourth-party principal in both simultaneous and delayed exchanges. The steps for completing an exchange are relatively simple.

- The exchanger signs a contract to sell a relinquished property to the buyer.
- The QI and the exchanger enter into the exchange agreement to retain the QI and the exchanger assigns the exchanger's rights in the sale contract to the QI, including the right to receive the exchange funds.
- At the closing of the relinquished property, the exchange funds are wired to the QI, who instructs the settlement officer to transfer the deed directly from the exchanger to the buyer.
- The exchanger has a maximum of 180 days in the exchange period (or until the tax filing deadline, including extensions for the year of the sale of the relinquished property), to acquire all replacement property.
- Unless the exchanger can acquire all replacement property within the first 45 days from the close of the relinquished property, the exchanger must identify possible replacement properties in writing to the QI within the 45-day identification period.
- The exchanger signs a contract to purchase the replacement property with the seller and the exchanger assigns the exchanger's rights in the purchase contract to the QI.
- At the closing of the replacement property, the QI wires the exchange funds to complete the exchange, and the QI instructs the settlement officer to transfer the deed directly from the seller to the exchanger.