

1031 Exchange

What is a 1031 Exchange?

People ask, "Why should I do a 1031 exchange?" This question can be answered in two words: "Financial Leveraging." By doing a 1031 exchange, the taxes you would have paid to the government are now working to earn you money.

A 1031 exchange allows a taxpayer to postpone their long-term capital gains tax when selling an investment property and rolling the proceeds from that sale into a new property. This gives an investor financial leverage. If you have a property used for investment or business and you plan on buying another property used for investment or business, **then yes**, you need to do a 1031 exchange.

It doesn't matter what the long-term capital gains tax is at the time. Why pay more taxes when you don't have to? Even the IRS agrees! That's why they created a 1031 tax code. It doesn't make sense to tax an investor on money they never actually received. And why not encourage investors to reinvest in the American real estate market? It is a Win-Win for everyone.

Why do a 1031 Exchange?

A 1031 is a section of the tax code that allows you to sell your investment property (almost any property other than your personal residence), buy a new investment property and defer all of the capital gains taxes from the old property to the new one.

This does three things for you:

1) you don't have to turn over to the government upwards of a third of everything you made on the property;

2) you now have all that extra money to spend on the new (replacement) property; and,

3) it may help you avoid the dreaded Alternative Minimum Tax (AMT). In short, its way of preserving your working capital as you build your real estate empire.

Here's an example: Let's say you have a property you have owned for several years. It's gone nicely up in value and the depreciation write-off has given you good cash flow. It's been a good investment, but what you'd really like is a property in a better location and in better condition. If you just sold the property to buy a new property without doing a 1031 exchange, your tax bite could be huge (25% for depreciation, 15% for federal capital gains, 0-11% for state capital gains, and then there's that dreaded AMT).

If, you did a 1031 exchange instead of just selling the property outright, all of those taxes you would have owed would be transferred (deferred) over to the new property. And all of the money you would have paid to the government is now available to buy a better property.

Of course, there are rules involved. If you're seriously contemplating doing an exchange and want to talk with an expert about your particular situation, [contact us](#) today for more details and we will set you up with one of our *Qualified Intermediaries* so you can start saving money on your next transaction. A Qualified Intermediary is an independent party who facilitates tax-deferred exchanges.

Five Misconceptions of 1031 Exchanges

Over the past 20 years, tax-deferred exchanges have become an increasingly important part of real estate transactions. Surprisingly, there are still some deep-rooted misconceptions about Section 1031 of the Internal Revenue Code, even though tax-deferred exchanges are prevalent in the real estate community today. Some of these misconceptions are so severe that real estate investors wind up losing their chance to take advantage of the tax savings afforded by structuring their transactions as an exchange. What follows are the five biggest misconceptions:

1. In order to complete a 1031 exchange, a taxpayer has to find someone to “swap” a property with.

While this is originally how exchanges were structured, taxpayers are now free to sell their property to anyone they wish, and to buy from anyone they wish. Although there are a few issues regarding sales and purchases between related parties, most exchanges are structured not unlike any other typical sale and subsequent purchase commonly found in the industry.

2. A taxpayer seeking to exchange property has to buy the exact same type of property he is selling in order for it to be considered a “like-kind” exchange.

As long as both the property to be sold and the property to be purchased are held for productive use in a trade or business, or for investment purposes, taxpayers are free to purchase whatever type of property they want. For example, a taxpayer can sell an apartment building and exchange it for an industrial warehouse. Although exchanges are a creation of federal law, taxpayers must also look to state law to determine what is considered real property. Based upon state law, some non-traditional interests in real property such as development rights, air rights and timber rights can also be exchanged in the process.

3. Taxpayers must complete the 1031 exchange in one completely simultaneous transaction.

By virtue of a favorable ruling to the taxpayer in the now famous case of *Starker v. United States* in 1979, taxpayers have the ability to complete an exchange on a delayed basis so long as they purchase replacement property within 180 days of selling their first

relinquished property. Other structures, including reverse exchanges and improvement exchanges, afford taxpayers other types of flexibility during the exchange time frame.

4. Taxpayers must use all the proceeds from the sale of their relinquished property to purchase replacement property.

In order to have a completely tax-deferred exchange a taxpayer must follow three essential steps: (1) buy replacement property where the value is equal to or greater than the value of the original relinquished property; (2) use all of the original equity realized from the sale to purchase a replacement property; and (3) obtain equal or greater financing on the replacement property as was paid off on the relinquished property at the time of its sale.

However, while those are the rules for a complete deferral, a taxpayer may violate any one of them and complete a partial deferred exchange. For example, a taxpayer who seeks to buy a replacement property of a lesser value, or with less financing, will recognize a capital gains tax on that amount not reinvested in the new property. Simply put, taxpayers can buy replacement properties for a lesser amount and put cash in their pocket, so long as they don't mind paying some taxes.

5. I don't need a Qualified Intermediary. I can simply have my attorney or accountant hold the sale proceeds until the replacement property is purchased.

A Qualified Intermediary is essential to completing a valid delayed exchange. Basically, the IRS disqualifies any person or entity from acting as an intermediary, if that individual has had an existing business relationship with the taxpayer within the past two years.

Although that statement is somewhat broad, some parties who may be considered disqualified parties are the taxpayer's relatives, attorney, accountant and real estate broker. The IRS states that neither the taxpayer, nor any disqualified person or entity, can come into receipt of the exchange funds during the exchange, or the exchange will be void. Using a well-established Qualified Intermediary enables a taxpayer to avoid situations that might void an otherwise valid exchange. It is also a good practice to research the expertise and security of the qualified intermediary.

To consult with one of our Qualified Intermediaries, [contact us](#) today for a free, no obligation consultation!

1031 Exchange - FAQ

Every Section 1031 Exchange transaction is different. These "Frequently Asked Questions" are intended to answer general inquiries. The application of these principles will depend on the specific facts of each transaction. Always consult a competent Qualified Intermediary, attorney, or tax advisor to determine how an exchange may best be structured to accomplish your investment objectives.

Q - What is a tax-deferred exchange?

In a typical transaction, the property owner is taxed on any gain realized from the sale. However, through a Section 1031 Exchange, the tax on the gain is deferred until some future date.

Section 1031 of the Internal Revenue Code provides that no gain or loss shall be recognized on the exchange of property held for productive use in a trade or business, or for investment. A tax-deferred exchange is a method by which a property owner trades one or more relinquished properties for one or more replacement properties of "like-kind", while deferring the payment of federal income taxes and some state taxes on the transaction.

The theory behind Section 1031 is that when a property owner has reinvested the sale proceeds into another property, the economic gain has not been realized in a way that generates funds to pay any tax. In other words, the taxpayer's investment is still the same, only the form has changed (e.g. vacant land exchanged for apartment building). Therefore, it would be unfair to force the taxpayer to pay tax on a "paper" gain.

The like-kind exchange under Section 1031 is tax-deferred, not tax-free. When the replacement property is ultimately sold (not as part of another exchange), the original deferred gain, plus any additional gain realized since the purchase of the replacement property, is subject to tax.

Q - What are the benefits of exchanging v. selling?

- A Section 1031 exchange is one of the few techniques available to postpone or potentially eliminate taxes due on the sale of qualifying properties.
- By deferring the tax, you have more money available to invest in another property. In effect, you receive an interest free loan from the federal government, in the amount you would have paid in taxes.
- Any gain from depreciation recapture is postponed.
- You can acquire and dispose of properties to reallocate your investment portfolio without paying tax on any gain.

Q - What are the different types of exchanges?

- Simultaneous Exchange: The exchange of the relinquished property for the replacement property occurs at the same time.
- Delayed Exchange: This is the most common type of exchange. A Delayed Exchange occurs when there is a time gap between the transfer of the Relinquished Property and the acquisition of the Replacement Property. A Delayed Exchange is subject to strict time limits, which are set forth in the Treasury Regulations.
- Build-to-Suit (Improvement or Construction) Exchange: This technique allows the taxpayer to build on, or make improvements to, the replacement property, using the exchange proceeds.
- Reverse Exchange: A situation where the replacement property is acquired prior to transferring the relinquished property. The IRS has offered a safe harbor for reverse exchanges, as outlined in Rev. Proc. 2000-37, effective September 15, 2000. These transactions are sometimes referred to as "parking arrangements" and may also be structured in ways which are outside the safe harbor.
- Personal Property Exchange: Exchanges are not limited to real property. Personal property can also be exchanged for other personal property of like-kind or like-class.

Q - What are the requirements for a valid exchange?

- Qualifying Property - Certain types of property are specifically excluded from Section 1031 treatment: property held primarily for sale; inventories; stocks, bonds or notes; other securities or evidences of indebtedness; interests in a partnership; certificates of trusts or beneficial interest; and choses in action. In general, if property is not specifically excluded, it can qualify for tax-deferred treatment.
- Proper Purpose - Both the relinquished property and replacement property must be held for productive use in a trade or business or for investment. Property acquired for immediate resale will not qualify. The taxpayer's personal residence will not qualify.
- Like Kind - Replacement property acquired in an exchange must be "like-kind" to the property being relinquished. All qualifying real property located in the United States is like-kind. Personal property that is relinquished must be either like-kind or like-class to the personal property which is acquired. Property located outside the United States is not like-kind to property located in the United States.
- Exchange Requirement - The relinquished property must be exchanged for other property, rather than sold for cash and using the proceeds to buy the replacement property. Most deferred exchanges are facilitated by Qualified Intermediaries, who assist the taxpayer in meeting the requirements of Section 1031.

Q - What are the general guidelines to follow in order for a taxpayer to defer all the taxable gain?

- The value of the replacement property must be equal to or greater than the value of the relinquished property.
- The equity in the replacement property must be equal to or greater than the equity in the relinquished property.
- The debt on the replacement property must be equal to or greater than the debt on the relinquished property.
- All of the net proceeds from the sale of the relinquished property must be used to acquire the replacement property.

Q - When can I take money out of the exchange account?

Once the money is deposited into an exchange account, funds can only be withdrawn in accordance with the Regulations. The taxpayer cannot receive any money until the exchange is complete. If you want to receive a portion of the proceeds in cash, this must be done before the funds are deposited with the Qualified Intermediary.

Q - Can the replacement property eventually be converted to the taxpayer's primary residence or a vacation home?

Yes, but the holding requirements of Section 1031 must be met prior to changing the primary use of the property. The IRS has no specific regulations on holding periods. However, many experts feel that to be on the safe side, the taxpayer should hold the replacement property for a proper use for a period of at least one year.

If the owner later on wants to take advantage of the home owner's exemption (up to \$250,000 or \$500,000 for a couple), there is now a five year holding period requirement.

Q - What is a Qualified Intermediary (QI)?

A Qualified Intermediary is an independent party who facilitates tax-deferred exchanges pursuant to Section 1031 of the Internal Revenue Code. The QI cannot be the taxpayer or a disqualified person.

- Acting under a written agreement with the taxpayer, the QI acquires the relinquished property and transfers it to the buyer.
- The QI holds the sales proceeds, to prevent the taxpayer from having actual or constructive receipt of the funds.
- Finally, the QI acquires the replacement property and transfers it to the taxpayer to complete the exchange within the appropriate time limits.

Q - Why is a Qualified Intermediary needed?

The exchange ends the moment the taxpayer has actual or constructive receipt (i.e. direct or indirect use or control) of the proceeds from the sale of the relinquished property. The use of a QI is a safe harbor established by the Treasury Regulations. If the taxpayer meets the requirements of this safe harbor, the IRS will not consider the taxpayer to be in receipt of the funds. The sale proceeds go directly to the QI, who holds them until they are needed to acquire the replacement property. The QI then delivers the funds directly to the closing agent.

Q - Can the taxpayer just sell the relinquished property and put the money in a separate bank account, only to be used for the purchase of the replacement property?

The IRS regulations are very clear. The taxpayer may not receive the proceeds or take constructive receipt of the funds in any way, without disqualifying the exchange.

Q - If the taxpayer has already signed a contract to sell the relinquished property, is it too late to start a tax-deferred exchange?

No, as long as the taxpayer has not transferred title, or the benefits and burdens of the relinquished property, she can still set up a tax-deferred Exchange. Once the closing occurs, it is too late to take advantage of a Section 1031 tax-deferred exchange (even if the taxpayer has not cashed the proceeds check).

Q - Does the Qualified Intermediary actually take title to the properties?

No, not in most situations. The IRS regulations allow the properties to be deeded directly between the parties, just as in a normal sale transaction. The taxpayer's interests in the property purchase and sale contracts are assigned to the QI. The QI then instructs the property owner to deed the property directly to the appropriate party (for the relinquished property, its buyer; for the replacement property, taxpayer).

Q - What are the time restrictions on completing a Section 1031 exchange?

A taxpayer has 45 days after the date that the relinquished property is transferred to properly identify potential replacement properties. The exchange must be completed by the date that is 180 days after the transfer of the relinquished property, or the due date of the taxpayer's federal tax return for the year in which the relinquished property was transferred, whichever is earlier. Thus, for a calendar year taxpayer, the exchange period may be cut short for any exchange that begins after October 17th. However, the taxpayer can get the full 180 days, by obtaining an extension of the due date for filing the tax return.

Q - What if the taxpayer cannot identify any replacement property within 45 days, or close on a replacement property before the end of the exchange period?

Unfortunately, there are no extensions available. If the taxpayer does not meet the time limits, the exchange will fail and the taxpayer will have to pay any taxes arising from the sale of the relinquished property, *unless the IRS has expressly granted extensions in specified disaster area(s)*.

Q - Is there any limit to the number of properties that can be identified?

There are three rules that limit the number of properties that can be identified. The taxpayer must meet the requirements of at least one of these rules:

- 3-Property Rule: The taxpayer may identify up to 3 potential replacement properties, without regard to their value; or
- 200% Rule: Any number of properties may be identified, but their total value cannot exceed twice the value of the relinquished property, or
- 95% Rule: The taxpayer may identify as many properties as he wants, but before the end of the exchange period the taxpayer must acquire replacement properties with an aggregate fair market value equal to at least 95% of the aggregate fair market value of all the identified properties.

Q - What are the requirements to properly identify replacement property?

Potential replacement property must be identified in a writing, signed by the taxpayer, and delivered to a party to the exchange who is not considered a "disqualified person". A "disqualified" person is any one who has a relationship with the taxpayer that is so close that the person is presumed to be under the control of the taxpayer. Examples include blood relatives, and any person who is or has been the taxpayer's attorney, accountant, investment banker or real estate agent within the two years prior to the closing of the relinquished property. The identification cannot be made orally.

Q - Are Section 1031 Exchanges limited only to real estate?

No. Any property that is held for productive use in a trade or business, or for investment, may qualify for tax-deferred treatment under Section 1031. In fact, many exchanges are "multi-asset" exchanges, involving both real property and personal property.

Q - What is a "multi-asset" exchange?

A multi-asset exchange involves both real and personal property. For example, the sale of a hotel will typically include the underlying land and buildings, as well as the

furnishings and equipment. If the taxpayer wants to exchange the hotel for a similar property, he would exchange the land and buildings as one part of the exchange. The furnishings and equipment would be separated into groups of like-kind or like-class property, with the groups of relinquished property being exchanged for groups of replacement property.

Although the definition of like-kind is much narrower for personal property and business equipment, careful planning will allow the taxpayer to enjoy the benefits of an exchange for the entire relinquished property, not just for the real estate portion.

Q - What is a reverse exchange?

A reverse exchange, sometimes called a "parking arrangement," occurs when a taxpayer acquires a Replacement Property before disposing of their Relinquished Property. A "pure" reverse exchange, where the taxpayer owns both the Relinquished and Replacement properties at the same time, is not allowed. The actual acquisition of the "parked" property is done by an Exchange Accommodation Titleholder (EAT) or parking entity.

Q - Is a reverse exchange permissible?

Yes. Although the Treasury Regulations still do not apply to reverse exchanges, the IRS issued "safe harbor" guidelines for reverse exchanges on September 15th, 2000, in Revenue Procedure 2000-37. Compliance with the safe harbor creates certain presumptions that will enable the transaction to qualify for Section 1031 tax-deferred exchange treatment.

Q - How does a reverse exchange work?

In a typical reverse (or "parking") exchange, the "Exchange Accommodation Titleholder" (EAT) takes title to ("parks") the replacement property and holds it until the taxpayer is able to sell the relinquished property. The taxpayer then exchanges with the EAT, who now owns the replacement property. An exchange structured within the safe harbor of Rev. Proc. 2000-37 cannot have a parking period that goes beyond 180 days.

Q - What happens if the exchange cannot be completed within 180 days?

If the reverse exchange period exceeds 180 days, then the exchange is outside the safe harbor of Rev. Proc. 2000-37. With careful planning, it is possible to structure a reverse exchange that will go beyond 180 days, but the taxpayer will lose the presumptions that accompany compliance with the safe harbor.

Q - Can the proceeds from the relinquished property be used to make improvements to the replacement property?

Yes. This is known as a Build-to-Suit or Construction or Improvement Exchange. It is similar in concept to a reverse exchange. The taxpayer is not permitted to build on property she already owns. Therefore, an unrelated party or parking entity must take title to the replacement property, make the improvements, and convey title to the taxpayer before the end of the exchange period.

Q- What is the difference between "realized" gain and "recognized" gain?

Realized gain is the increase in the taxpayer's economic position as a result of the exchange. In a sale, tax is paid on the realized gain. Recognized gain is the taxable gain. Recognized gain is the lesser of realized gain or the net boot received.

Q - What is Boot?

Boot is any property received by the taxpayer in the exchange which is not like-kind to the relinquished property. Boot is characterized as either "cash" boot or "mortgage" boot. Realized Gain is recognized to the extent of net boot received.

Q - What is Mortgage Boot?

Mortgage Boot consists of liabilities assumed or given up by the taxpayer. The taxpayer pays mortgage boot when he assumes or places debt on the replacement property. The taxpayer receives mortgage boot when he is relieved of debt on the replacement property. If the taxpayer does not acquire debt that is equal to or greater than the debt that was paid off, they are considered to be relieved of debt. The debt relief portion is taxable, unless offset when netted against other boot in the transaction.

Q - What is Cash Boot?

Cash Boot is any boot received by the taxpayer, other than mortgage boot. Cash boot may be in the form of money or other property.

Q - What are the boot "netting" rules?

- Cash boot paid offsets cash boot received
- Cash boot paid offsets mortgage boot received (debt relief)
- Mortgage boot paid (debt assumed) offsets mortgage boot received

- Mortgage boot paid does not offset cash boot received

Q - I bought the property as a single person and I would like to acquire the replacement property together with my spouse?

The most conservative way is to stay consistent and complete the exchange the same way it was started and to add the spouse after the completion of the exchange. An exception can be made if there is a lender requirement that the spouse has to be added in order to qualify for a loan. If an exchange is planned well ahead of time, another solution would be to add the spouse to the title of the currently held property. Timing should be discussed with the CPA.

Q - I closed escrow on my first replacement property within the 45 day identification period. Can I now identify three more properties within my 45 day identification period?

If you are using the three property rule, the completed acquisition counts as one and you may identify only up to two additional properties.

Q - How do I identify two different properties (or percentages of ownership through a TIC) covered by ONE purchase contract?

If the properties could be sold separately at a later date, they should be identified as two properties.

To learn more about 1031 Exchanges or to talk with one of our Qualified Intermediaries, [contact us](#) today for a free, no obligation consultation and save on your next real estate transaction!