



**National1031ExchangeConsultants**

**Special Report:  
1031 Exchanges**

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# Special Report:

# 1031 Exchanges

## **SECTION 1**

### 1031's: THE BASICS OF LIKE-KIND EXCHANGES

Before the advent of tax-deferred like-kind exchanges in 1921, real estate investors paid capital gains taxes every time they sold a property in the United States. Section 1031 of the Internal Revenue Code changed that, providing investors with a means to delay tax payments and an incentive to reinvest. With the addition of several beneficial amendments to the code in 1991, Section 1031 may now be the most powerful tool available for investors to build equity in the real estate market. The wisdom behind the 1031 is the belief that investors who exchange one property for another like-kind property are simply reinvesting profits—any financial gains realized are paper profits only and would therefore not generate funds from which to pay taxes. This simple philosophy has allowed real estate investors of all sizes to reinvest their returns without hindering cash flow. In fact, many experts attribute the popularity of the 1031 exchange to the growing number of individual real estate investors. Through the use of a 1031 exchange, real estate investors are able to build wealth faster because money that would have been paid toward taxes is reinvested into the ownership of the new property.

### **How a 1031 Works**

In its simplest definition, a like-kind exchange allows investors to exchange one property for another while deferring all income taxes on profits from the sale. This does not mean, however, that two parties actually swap properties. Rather, it works like this: (1) you, the investor (or exchanger), sell your property to an unrelated buyer; (2) before closing, you enter into an arrangement with a Qualified Intermediary (QI) who will oversee the legalities of the transaction; (3) once the transfer of property from you to the buyer has occurred, your

buyer transfers the exchange proceeds to the QI; (4) the QI holds the funds until you identify and purchase a like-kind property from a seller. To qualify under 1031 regulations, you have 45 days in which to identify property to purchase and 180 days to close the sale.

### **Anatomy of a Tax-Saving 1031 Exchange**

*Joe Miller decides that after 10 years of managing rental property, he would like to sell his building and invest in undeveloped land. He purchased the building in 1997 for \$400,000, and he is now able to sell it for \$650,000—a profit of \$250,000. If he keeps the gain, he will owe capital gains on the full value of the appreciation (in this case, \$250K, less depreciation and expenses). If instead he is able to identify a piece of investment land within 45 days, and close on the sale with 180 days, he can defer payment of income taxes on the entire value of his profit. And with the capital gains tax currently at 15 percent for most investors, Joe is preserving a considerable portion of his investment. *If the property is owned by a Corporation, the tax rate is 44%, not 15%**

Of course, this is only a basic overview of how such an exchange works. There are many layers of tax code that stipulate what types of exchanges and property are eligible, as well as the procedures that must be followed. We will outline each of these issues in more detail later in this report.

### **Tax and Financial Benefits**

Real estate, like many other investment markets, is driven partly by tax incentives. Lawmakers know this and write tax codes to encourage investment behavior that is beneficial to the overall economy. Property values across the United States have soared since the 1990s, and many believe relaxed real estate tax codes, such as the 1031, are largely responsible for the growth.

### ***Defer Taxes***

The most obvious benefit of the 1031 exchange is it allows investors to avoid paying capital gains and depreciation taxes that would normally be levied at the time of sale on real estate. (It is important to remember like-kind exchanges **DEFER**, rather than eliminate, the eventual payment of capital gains taxes.) Delaying the tax due increases an investor's buying power by providing additional equity to invest and greater leverage in the market. It is, in effect, an interest-free loan from Uncle Sam so you can reinvest your profits without penalty. Plowing the proceeds from one sale into the next can save most investors as much as 15 percent in taxes. If the property is owned by a corporation, then the tax rate starts at 44 percent.

Taxpayers also save on state capital gains taxes; 48 of the 50 states currently grant 1031 exchange deferral on state income taxes. In Oregon and South Carolina, the property received in an exchange must be located in the same state to qualify for the deferral.

### ***Build Wealth***

As a vehicle for wealth accumulation, the 1031 gives real estate investors several advantages over other investment strategies. Because there is no limit to the number of exchanges individuals can transact in a lifetime, an investor can move equity from one investment to the next, building assets tax-free. And an added benefit for those passing an estate along to their children is the tax liability accrued during the investor's lifetime is forgiven at death. Why? Because heirs benefit from the property's stepped-up basis. This means when heirs receive property from an estate the cost basis of the asset is calculated at the current fair market value (the stepped-up basis) rather than the original cost to the buyer. As the value of the asset increases during the recipient's lifetime, taxes are calculated based only on appreciation from the time of receipt. The same holds true for assets that depreciate. For example, assume you inherited a tract of land with a stepped-up value of \$2 million. After 10 years, you decided to sell and were only able to get \$1.5 million for the property. According to the IRS, you have sustained a capital gains loss of \$500,000 that can be written off your taxes.

## **Properties That Qualify**

Property is a general term used by the IRS that includes personal property and real property, both of which can be exchanged under the 1031 tax code. Though real estate still accounts for the vast majority (95 percent) of exchanges, personal property exchanges are slowly growing in popularity as individuals discover its financial benefits. In fact, the tax advantages of exchanging some personal property are even greater than real property. One such example is collectible items. With the capital gains tax on such items currently at 28 percent, the benefit is far greater than the 15 percent in taxes saved on real estate.

Regardless of the type of property being exchanged, to meet the Internal Revenue Code requirements for a 1031 both the property being sold and the property being purchased must meet the qualifying-use standards outlined in the code. In this section, we define the various state and federal understandings of property types and outline those properties that are considered qualified use. Be aware by federal law, each state is allowed to define real and personal property in its own way. So what qualifies as one type of property in your state may be considered a different type in another. Check with a 1031 advisor for information on specific state regulations.

### ***Real Property***

To help understand the definition of real property as it relates to 1031 exchanges, consider the following four basic IRS classifications of property:

1. Property held for personal use (personal property)
2. Property held primarily for sale (dealer property)
3. Property held for use in a trade or business (business property)
4. Property held primarily for investment purposes (investment property)

If your property falls in either of the last two categories (3 or 4), it is considered a qualified use and is eligible for a 1031 exchange. In other words, it must be used or held for the purpose of generating income (such as rental property), as an investment, or as a means of

running a trade or business. The following examples are considered qualified use:

- Residential apartment buildings or houses
- Undeveloped land
- Commercial and residential rental property
- Industrial property
- Hotels
- Commercial office buildings or shopping centers
- A percentage of interest held in investment property
- Farms
- Oil and gas royalties

If your property is classified in either of the first two categories below, it is most likely not eligible. The following are examples of property that do not qualify for like-kind exchanges:

- Primary residences
- Vacation homes for personal use (it may qualify if rented, however)
- Stocks, bonds or notes
- Securities
- Partnership or limited liability company (LLC) interests
- Stock in trade or inventory

One exception to the primary residence exclusion is home office space. If you run a business out of your home, the percentage of your home that qualifies for the home office deduction on your tax returns is eligible for exchange. So, if your home office is 15 percent of the square footage of your house, 15 percent of the capital gain on your home is exempt from income taxes if you locate another office space and exchange up with a 1031.

### ***Personal Property***

Personal property, according to the IRS, is generally considered those items owned by an individual that can be moved (i.e., they are not attached to the ground or some other structure). Such items can be tangible or intangible and, like real property, must be used for trade, business or investment purposes. Examples of tangible property that may qualify for a like-kind exchange include the following:

- Commercial jets and corporate aircraft
- Fleets of vehicles, such as taxis or trucks
- Computer equipment
- Precious coins, art, and other collectible items
- Machinery
- Office furniture, fixtures and equipment
- Livestock

Intangible personal property is considered those assets that are non-depreciable.

Examples include the following:

- Franchisee licenses
- Copyrights
- Collectibles
- Television licenses

Dealers in real or personal property—those individuals who make a living buying and selling property—are not eligible to take a 1031 exchange exemption. The IRS considers the overall number and frequency of sales when determining whether an individual disqualifies.

### ***Multi-Asset***

An investor with both real and personal property to exchange—such as the owner of a furnished apartment building with maintenance equipment, fixtures and furnishings—

may be able to arrange a 1031 exchange in a single transaction. Such an exchange is handled by grouping properties by type (such as furnishings) and trading up for like-kind replacement properties. A small restaurant owner changing careers could, for example, exchange the value of her land and building (real property) as well her kitchen appliances and equipment (personal property) for, say, an art studio with materials and supplies included in the transaction.

### **Eligibility: Meeting with IRS Approval**

All U.S. taxpayers, regardless of income or tax status, are eligible to take a 1031 exemption as long as they meet the requirements put forth by the IRS. There are four general exchange requirements, which are detailed below. Also note in a properly structured exchange, sellers reinvest the entire proceeds from the sale of their first property into their second property. If they do not, the difference is considered “boot” and will be taxed as a capital gain. Taxable boots are discussed further in section 3.

### ***Constructive Receipt***

This rule relates to the handling of funds during the exchange transaction. To qualify for a capital gains tax deferral, the seller must follow strict regulations to avoid the IRS definition of *sale* rather than *exchange*. If the seller receives (or has access to) any proceeds from the sale of the first property before purchasing a second, the transaction is considered a sale and not an exchange. A seller is considered to be in *constructive receipt* of the funds if proceeds are credited to his account, set apart in a separate account for him or made available in any form for his personal use. Constructive receipt will nullify the terms of the exchange. Since 1991, the tax code has required funds from the first sale must be held by a third party (*a Qualified Intermediary aka QI*) until a like-kind property is purchased.

### ***Proper Purpose***

Proper purpose is perhaps the most important tenet of the 1031 tax code and the one most likely to land individuals in court over misinterpretations. Any properties exchanged

under section 1031 must be used *principally* for investment or business purposes to qualify for tax deferral. The code itself states tax deferrals are granted only “on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind which is to be held either for productive use in a trade or business or for investment.” Problems arise when individuals decide to trade up a vacation home under 1031, claiming it qualifies as investment property, or buying a rental unit and immediately converting it to a single-family home. Though there are ways around some proper use restrictions, it is safer to follow the letter of the law or consult a 1031 Qualified Intermediary for advice.

### ***Like-Kind Requirements***

Properties exchanged under a 1031 are required to be of like kind, meaning real property must be replaced by real property and personal property by personal property. The term *like kind* refers to the intended use of the property rather than its nature or quality. Therefore, the properties need not be similar—that is, rental property for rental property or land for land. This is a common misunderstanding. Like kind simply means that investment property must be exchanged for other investment property.

You may not, for example, legally exchange your rental apartment building for a vacation home you intend for personal use only, even if you consider it an investment. This is not to say that such a transaction has never been completed successfully. Many tax and legal advisors will tell you it *is* possible to prove a vacation home was purchased for investment purposes, even if the owner has no intention of renting it out. The legal precedent for this is still shaky, however, so proceed with caution and, as always, consult the professionals before making any plans.

### ***Time Limitations***

The 1984 Tax Reform Act imposed time restrictions on all 1031 transactions. Investors would no longer be able drag their feet while deciding when and where to invest in their next property. From the time an individual relinquishes the first property until a replacement property is purchased, two time requirements are now in force:

- 1. The 45-Day Identification Rule.** This restriction requires exchangers looking to complete a 1031 exchange identify potential replacement property within 45 days of transfer of the relinquished property. If replacement property is found and received (that is, title is transferred) within the 45-day window, the identification period requirement is considered met. If not, an identification notice—with a detailed legal description of the replacement property—must be drafted, signed by the exchanger and delivered to the Qualified Intermediary by the 45<sup>th</sup> day.
- 2. The 180-Day Exchange Period.** The exchanger has 180 days following 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 comes first), to close on the exchange property. What this means for a calendar-year taxpayer is the exchange period may be shortened for exchanges beginning in late October through the end of the year. You can work around this issue by obtaining a tax-filing extension, however.

When searching for replacement property, keep in mind more than one potential property may be identified, as long as you meet one of the following rules:

- **Three Property Rule.** A maximum of three properties can be identified, regardless of their fair market value.
- **200 Percent Rule.** An unlimited amount of properties may be identified as long as their aggregate fair market value does not exceed 200 percent of the value of the relinquished property.
- **95 Percent Rule.** An unlimited number of properties may be identified as long as by the end of the exchange period (180 days), the aggregate value of all properties purchased equals at least 95 percent of the value of the relinquished property.

If the four general 1031 exchange requirements outlined above (constructive receipt, proper purpose, like-kind property and time restrictions) are not met, the IRS will

recognize a gain (or loss) on the exchange. However, there may be some instances in which a taxpayer prefers to have a gain (or loss) recognized. Examples include obtaining a stepped-up basis on a property, offsetting a loss or recognizing a loss already realized. In such cases, it is best to structure the transaction outside the rules of section 1031, as the deferred tax benefit is mandatory, not optional.

## **SECTION 2**

### **TYPES OF EXCHANGES**

Though all 1031 exchanges share the same basic characteristics outlined in the previous section, they can be structured in various ways. The following are the most commonly used types of exchanges.

#### **Deferred Exchange**

Sometimes called a forward-delayed exchange or starker exchange, the deferred exchange is now the most common of all 1031 transactions. It is named for the landmark *Starker v United States* case in 1979 that sanctioned the extended timeframe for purchasing replacement property and led to important 1031 tax code changes in the Tax Reform Act of 1984. Until this time, all exchanges were required to close simultaneously.

In a deferred exchange, property is exchanged for replacement property within 180 days of closing on the relinquished property. The exchanger is given 45 days in which to identify replacement property and 180 days to close the deal. A deferred exchange requires the use of a Qualified Intermediary (QI), who holds the proceeds from the first sale until they are needed for the purchase of the replacement property. Use of a QI is considered by 1991 U.S. Treasury regulations the only *safe harbor* from legal reproach.

#### **Simultaneous Exchange**

This type of exchange occurs when one property is sold and another one purchased in the same transaction. Multiple parties and properties can be involved. The following are the three

types of simultaneous exchanges:

### ***Two-Party Exchange***

In a two-party exchange, two property owners agree to trade, or swap, deeds. This is probably the least common of the exchange types simply because of the unlikelihood of finding two parties willing to trade properties at the same time with one another. Also problematic is if equity and debt values on the properties differ, one party will be required to pay a boot (capital gains taxes on the portion of proceeds that is not reinvested). The advantage of this exchange is no Qualified Intermediary is needed for the transaction.

### ***Three-Party Exchange***

A three-party exchange also involves only two properties being swapped between two parties. The third party involved in this transaction serves as the *accommodating party*, so named because this individual helps accommodate the transaction by acting as a conveyer of deeds between the two parties. Tax advisors often discourage this type of exchange because of its potential for problems. Unless the exchange occurs at the same location, the accommodating party could be stuck holding a property deed from the first sale if the second sale falls through due to financing or some other issue.

### ***Multiparty Exchange***

As the same implies, multiple parties are involved in the purchase and sale of exchange property in this type of exchange. Because a taxpayer looking for replacement property is unlikely to find a buyer willing to make an exchange for his property, he will probably be selling to one party and buying from another. If the closings for all of these transactions can be arranged in one day, it is considered a simultaneous multiparty exchange.

This type of exchange can be handled without the services of a Qualified Intermediary if either the buyer of the relinquished property or the seller of the replacement property agrees to act as an accommodating party. However, to protect everyone's interests and ensure all 1031 parameters are satisfied, enlisting the services of a QI is a smart move.

## **Tenancy in Common (TIC) Exchange**

A TIC exchange is one in which a taxpayer acquires fractional ownership in an investment property, such as an apartment building, shopping mall or office building, rather than a single property. Shares of gas and oil interest are also considered fractional ownership and qualify as like-kind investment property in a 1031 exchange. TICs have only been around since the early 1990s, but interest in them has skyrocketed since Congress qualified them as like-kind investments for use in 1031 tax-deferred exchanges in March 2002.

### ***Role of the Sponsor***

TICs are purchased through sponsors, companies specializing in secured TIC transactions designed for 1031 exchanges. Most sponsors will specialize in certain types of property (e.g., shopping malls, apartment complexes or commercial office buildings) or certain geographic areas. The sponsor's role is multifold and includes locating property for clients, securing financing, handling legal documentation, managing the property (or arranging for management services), providing cash disbursements and ongoing financial updates to owners, and overseeing the eventual sale of the property, along with distribution of proceeds. If you are doing an exchange through a real estate sponsor and not through a security sponsor, you also have the advantage of liquidating your interest at any time. 1031 exchanges provided by real estate sponsors may also eliminate a large amount of fees that are involved in any real estate transaction.

### ***Benefits versus Risks***

One benefit of a TIC exchange, in addition to deferral of taxes, is it allows taxpayers to invest in higher-value property, potentially increasing investment returns. It also provides individuals an opportunity to invest in managed property without the personal time commitment of active management, and many TICs provide a steady flow of cash as well. But there are drawbacks. Most investors consider lack of liquidity the chief downside of this type of exchange. TIC purchasers pool their resources as part of a group investment; the deals are structured for all players to stay in the game for the length of the transaction. There is no readily available aftermarket for this type of fractional ownership as most real estate

brokers are unqualified—selling a secured TIC requires a securities license—or unwilling to handle the complexities involved. To sell your share of a TIC, your best bet is a TIC sponsor licensed to sell them as securities. Another option is to find a fellow TIC holder in your investment group to buy out your share of ownership.

Doing an exchange through a **real estate sponsor and not through a securities sponsor** does eliminate most of the issues with liquidation. A real estate TIC sponsor like will supply you with an individual deed and not a group deed. This allows you the option to sell you interest at any time or if you want you can wait for the group to sell. It also allows any real estate agent the ability to list and sell your TIC ownership. A TIC sold as real estate and not as a security also gives you more control over key issues from the management of your property to review of tenant agreements. Real estate sponsors also make sure that 100% of your money goes into the ownership of the property eliminating the high fees involved in securities transaction. Additional benefits are that your ownership will be set up at no cost to you in an LCC to insulate you from liability. In addition to providing non-recourse financing with practically no pre payment penalties, some real estate TIC sponsor do not require that you be an accredited investor or have a net worth of over one million dollars to participate. Sponsors allow for TIC participation from as little as \$50,000 making 1031 exchanges available to a much larger group of main stream investors. They also at no charge allow you to offer for sale your TIC ownership to their entire client data base if you choose to sell before the entire TIC group.

TIC ownership done as real estate also give the participant the ability resell just a portion of their holdings or to pass onto their heirs varying amounts of ownership through individually held deeds.

### **Reverse Exchange**

A reverse exchange works in much the same way as a deferred exchange, only backwards. That is, the replacement property is purchased **before** the sale of the relinquished property. IRS timelines for sale and purchase must still be met, but in this case, the exchanger is given 45 days to formally identify the property being relinquished and

180 days to close on the sale. This type of exchange also requires the use of two intermediaries, and in order to qualify for 1031 status, a Qualified Exchange Accommodation Agreement must be entered into within 5 business days after the purchase of the replacement property.

Title to this newly purchased property must be held by the first intermediary, an Exchange Accommodation Titleholder (EAT), until the relinquished property is sold. Following the sale of the relinquished property, title and proceeds are transferred to the second intermediary, a Qualified Intermediary, who then purchases the replacement property from the EAT on behalf of the taxpayer. Both intermediary roles can be handled by the same individual or exchange service. Because of the complexity and increased number of players involved in this type of transaction, fees are necessarily higher, too.

A reverse exchange is a smart option for investors who stumble upon investment property and want to act quickly to secure it, or simply those who feel more comfortable lining up acceptable replacement property before letting go of their original property. A reverse exchange is, however, considered one of the more complex like-kind exchanges to undertake and should be handled carefully and only with the help of experienced professionals.

### **Construction Exchange**

A construction exchange, sometimes known as a build-to-suit exchange, allows taxpayers to build or make improvements to a property before acquiring it as replacement property in a like-kind exchange. Examples include new construction on a vacant lot or capital improvements to an existing building.

The chief constraint with this arrangement is that all building work needed to satisfy the 1031 tax code requirements has to be completed before the property is acquired. Any work completed after title has transferred is not considered replacement property for the purpose of a 1031 exchange.

### ***Multiple Intermediaries***

Like in a reverse exchange, a construction exchange requires the services of two intermediaries: an Exchange Accommodation Titleholder (EAT) and a Qualified Intermediary (QI). Once an exchanger has sold a relinquished property, the proceeds are conveyed to a QI who holds the funds until they are needed to close on the replacement property. Qualified Intermediaries may, in some circumstances, also arrange for work to be completed on the property given all funding for the work must be made from the proceeds in their possession. Meanwhile, the EAT holds title to the replacement property until the exchange-defined building requirements (see below) have been met. At that time, and within the 180-day window allowed by section 1031 provisions, the exchanger closes on and takes title to the newly improved replacement property.

### ***Structuring the Exchange to Increase Value***

#### **TIP**

#### **Consider Combining IRS Codes 1031 and 121 to Double Your Gains**

*You are probably aware of the tax benefits of Internal Revenue Code Section 121, which provides homeowners with a \$250,000 (\$500,000 for those married filing jointly) capital gains tax exemption on the sale of their principal residence if they have lived there for at least 2 of the past 5 years. But did you know if your home and business are one and the same you can combine the benefits of both IRC tax codes 1031 and 121? For example, if you own a building with a retail store on the first level and your residence on the second, when you sell the building, the business portion on the first floor is eligible for a 1031 tax deferred exchange and your home on the second level is exempt from capital gains taxes under the guidelines of Section 121.*

One key advantage of a construction exchange is it allows taxpayers to acquire replacement property valued less than their relinquished property. The only caveat with the arrangement is the debt liability on the replacement property must equal or exceed the relinquished property to avoid receiving cash out of the transaction (a mortgage *boot*, as discussed earlier) subject to taxes. Therefore, the total cost of construction improvements to

the property must equal the difference in value between the two debt liabilities to qualify for 100 percent tax deferral. In other words, all proceeds from the relinquished property must be reinvested into the replacement property in whatever combination of purchase price and construction improvements necessary.

### **SECTION 3**

#### **USING EXCHANGES SUCCESSFULLY**

There is no doubt a 1031 exchange is one of the best tools available to investors wishing to grow a real estate portfolio. Tax-deferred capital gains can move from property to property throughout a taxpayer's life, growing in value, and even be passed along to heirs with no tax consequences. So how do you take advantage of this amazing opportunity?

Ensure the transaction is carried out according to federal exchange regulations, which requires some advance planning, the help of a few qualified professionals, and a good deal of diligence.

Here are a few tips to make sure your transaction runs smoothly.

#### **Plan in Advance**

When considering any type of investment, ask yourself a few questions:

1. How much time do I have to devote to the oversight and management of this investment?
2. How quickly do I expect my money to grow in value?
3. Do I need liquidity (that is, can I cash out quickly if needed)?
4. Am I in this for the long haul or am I looking to turn a short-term profit?

***Once you have a general idea of your investment goals, decide on a game plan.***

If you already own investment property and are considering trading up into another similar investment, talk to us, a real estate professional about the benefits of different like-kind exchanges. If you are more comfortable finding replacement property before selling your current one; then a reverse exchange may make sense. Or, if you are currently a rental property owner looking to give up the hassles of day-to-day management but want to stay in the real estate market, then a tenancy-in-common (TIC) investment may be the way to go. Whatever your goals, consider the many 1031 options available so you can narrow your choices to those best fitting your best.

Another type of real estate investment which is perfect for using in a 1031 exchange, are NNN (Triple Net) investments. Those are usually Single-Tenant building properties that the tenant pays all the taxes, insurance, repairs & maintenance. The tenant sends you 1 check a month to cover your mortgage...if you have one. There are not any management responsibilities by you as the property owner. You can become an “Armchair Investor”, one that sits in an armchair and waits for the monthly rent checks come to you.

### **Enlist the Professionals**

The vast complexity of the U.S. tax code leaves most taxpayers confused over their 1040s each year. Add the intricate layers of investment and capital gains regulations and rulings, and many people soon find themselves in over their heads.

**Though it is possible to structure your own 1031 exchange legally, it may not be the smartest move. Countless companies specialize in managing like-kind exchanges, and in most cases it makes sense to enlist their services. These companies include: Qualified Intermediaries (QI), attorneys, tax accountants and other exchange experts to help you through the process. With an exchange professional managing the details of your 1031, you get peace of mind and also gain safe harbor from IRS regulators. Just ask us, we can help point you in the right direction.**

Safe harbor was established by Treasury Regulations to guarantee taxpayers immunity from constructive receipt during the process of an exchange by having a Qualified Intermediary hold all funds during the transaction.

## **A Step-by-Step Overview of the Process**

It is important to understand how a 1031 exchange is configured before beginning the process. Though all exchanges vary somewhat in their structure, the following are the most typical steps in the process:

- 1. Sale of Relinquished Property.** Finding a buyer for the soon-to-be-relinquished property is most often the first step in the exchange process. Once a contract is signed, and before closing occurs, arrangements must be made for the proceeds from the sale to be held by a neutral party to avoid constructive receipt (acceptance of funds) by the seller. This is the time during which many sellers sign a contract with a Qualified Intermediary to handle the exchange.
- 2. Agreement with Qualified Intermediary.** Once a purchase contract is signed by both parties, sellers may choose to secure the services of an exchange company to act as a QI and coordinate the exchange. Because this industry is largely unregulated, it is important to choose someone with experience and a solid reputation. Be aware, too, the Internal Revenue Code does not allow your lawyer, accountant, real estate broker or relatives, among others, to act as a QI on your behalf. If a QI is used, all proceeds from the sale will be transferred to that party at the closing for holding. Following the closing, the formal identification period for replacement property begins.
- 3. Identification of Replacement Property.** This is a 45-day period in which the IRS allows taxpayers time to locate and identify, in writing, possible replacement properties. An Identification Statement must be drafted that identifies like-kind properties in accordance with the three rules of identification outlined in the first section of this report.
- 4. Purchase of Replacement Property.** Taxpayers have up to 180 days to finalize the purchase of replacement property. The time limit is not negotiable and strictly enforced. Holidays and weekends count toward the number of days.

## **Avoiding Common Mistakes**

Novices to the like-kind exchange process often make critical mistakes that end up costing them money or, worse, disqualify their transaction from 1031 benefits. Pay attention to the following to ensure your exchange is a smooth one.

### ***Incurring a Boot***

In a properly structured exchange, all proceeds from the sale of the relinquished property are reinvested in the replacement property. When less than the entire proceeds are rolled over, a *boot* is created and must be taxed as a capital gain. For example, if you were to sell your original property for \$750,000 and buy replacement property valued at \$500,000, you would incur a \$250,000 boot (capital gain) on which taxes would be due.

Boots apply not only to property values but also to mortgage debt. That is, the debt carried on the replacement property must equal or exceed the debt carried on the relinquished property; if not, a mortgage boot is created unless it is offset by a cash investment of equivalent value in the new property. In sum, make sure you are trading up when you reinvest your funds or you will still be responsible for capital gains taxes.

### ***Taking Possession of Proceeds on Relinquished Property***

Many sellers unfamiliar with exchange requirements make the mistake of selling their investment property before contacting a Qualified Intermediary to set up an exchange. Once a closing occurs on a property, and a seller takes possession of the proceed funds, a 1031 can no longer be executed. The seller has violated a cardinal rule of like-kind exchanges—constructive receipt. As discussed earlier, a neutral third party must control all funds from the sale of the original property until a replacement property is purchased.

### ***Overlooking Holding Requirements***

In addition to transacting the property exchange within a specified time frame, the IRS also requires that the replacement property in a 1031 be held for an acceptable amount of time. Though the federal code does not specify what it considers a reasonable holding time for new property, most experts say that 2 years is a safe rule of thumb. Selling earlier may raise a red flag to the IRS indicating that you had no intention of using the replacement property as a means to generate income.

### ***Overlooking Exchange Deadlines***

It is vital to remember once you close on the sale of your first property, the clock starts ticking on the IRS time restrictions for a 1031 exchange. In review, you have 45 days to identify (in writing) possible replacement property and 180 days from the date of sale or your next tax filing deadline to close on it. A common mistake occurs when taxpayers miscalculate the 180-day deadline for late-year exchanges. For example, a taxpayer who closes on relinquished property December 20 must complete the entire exchange process by April 15, which shortens the 180-day period by 65 days. This is important information to consider when initiating an exchange, especially if you do not have acceptable replacement property lined up.

## **SECTION 4**

### **TIPS AND RESOURCES**

This section serves as a brief review of the previous sections, and it also provides several important links to help further your education about the benefits and workings of like-kind exchanges.

### **Five Misconceptions about Exchanges**

#### ***1. Exchanges Are Complicated and Only for Wealthy Investors***

Like-kind exchanges are available to all taxpayers and can benefit small and large investors alike. There is no minimum dollar amount required to complete an exchange, and most

exchangers find the process straightforward, especially with the guidance of a skilled intermediary.

## ***2. Only Real Estate Qualifies for Exchange***

Personal property, both tangible and intangible, is also eligible for like-kind exchange. Examples of tangible personal property include aircraft, automobile fleets, livestock, furniture, computers, construction equipment and machinery. Intangible property eligible for exchange includes collectibles (coins, stamps and artwork), broadcast licenses, copyrights and franchise licenses.

## ***3. Exchanges Require Two Parties to Trade Properties***

In fact, most exchanges involve multiple buyers and sellers. Though a simultaneous exchange (in which two parties actually swap properties) is possible, it is a rare event. Tax code changes that introduced the deferred exchange in 1984 had a major impact on 1031 exchanges, and today virtually all sales and purchases within an exchange are handled as separate transactions.

## ***4. Like-Kind Requirements Limit the Usefulness of 1031 Exchanges***

Like kind is a general term used to indicate the intended use of the property being exchanged and is, for the most part, broadly interpreted in real property exchanges. As long as the property being sold and the property being purchased are both intended for investment or business use, the transaction is qualified for 1031 purposes. Personal property exchanges are more restrictive in their definition of like kind, as the assets being exchanged must fall into one of the same three categories: asset class, product class, or exact match. For example, gold bouillon can be exchanged for gold coins but not for silver coins.

## ***5. Exchanges Are Limited to One Relinquished Property and One Replacement Property***

Property can be exchanged in groups, whether personal or real property. For instance, if you currently own a large tract of raw land, it is possible to purchase three residential

apartment buildings as replacement property. Personal property exchanges are often transacted in groups (i.e., fleets of vehicles or aircraft, office furniture, or construction equipment), though items exchanged must meet like-kind requirements for personal property.

## **Frequently Asked Questions**

*If I already have a contract on my property, is it too late to start a 1031 exchange?* No. As long as you have not transferred title (closed) on the property or received any proceeds from the sale, you still have time to set up a tax-deferred exchange.

*What if I cannot identify replacement property within 45 days or manage to close on it within 180 days?*

Unfortunately, your transaction would not be eligible for tax-deferred status. The Internal Revenue Codes on time restrictions are clear, and no extensions are available.

*When, if ever, do I owe the capital gains taxes deferred on an exchange?*

Taxes are due only when you sell the replacement property. If you pass along replacement property to your heirs, no capital gains taxes will be due as they will take ownership on a stepped-up basis (that is, the property will be revalued at current market levels).

*Can my accountant, attorney or real estate agent serve as an intermediary?*

No, or at least not usually. Certain individuals, known as interested parties, are prohibited from serving as intermediaries in an exchange transaction. The IRS has clear guidelines regarding this issue, and anyone serving as an agent of the investor (or who has worked with the investor in such a capacity in the past 2 years) is considered a Disqualified Person under Section 267(b) and 707(b) of the Internal Revenue Code. Please ask us for recommendations for only experienced, bonded QI's

***Do I have to spend all of the proceeds on my relinquished property on the replacement property?***

No, but be aware that any proceeds not rolled over into the new property will be considered boot and taxed as a capital gain.

***Do all properties need to be located in the United States to be eligible for a like-kind exchange?***

No, but relinquished U.S. property must be exchanged for other U.S. property (including some U.S. territories) to be considered like kind. Non-U.S. properties may be exchanged for other non-U.S. properties.

***What are the typical fees charged by Qualified Intermediaries?***

These fees range from about \$500-\$900 for a simple deferred exchange to up to \$4000 for a more complex reverse exchange. Rates will vary depending on whether the intermediary is affiliated with a larger institution.

***I plan to sell my rental apartment building; do I have to replace it with another rental property to be qualified for like-kind status?***

No. The guidelines regarding like-kind assets refer only to the business or investment use of the property in general, not the specific type of business being conducted.

***Can I exchange my commercial business property for a vacation home if the home is located in a high-growth area?***

No, not unless you are purchasing the vacation home solely as an investment property and can prove as much to the IRS. Proper evidence would include proof of rental activity on a regular basis.

***I only have one property to sell, but I would like to purchase two replacement properties. Is this legal?***

Yes. Purchasing (or selling) multiple properties is allowed as long as all other exchange requirements are met. It may, however, be simpler to handle each transaction separately.

***Can I purchase replacement property that is not yet built?***

Yes, this is known as a Construction (or Build-to-Suit) Exchange and it is a more complex transaction. In this arrangement, title to the property is held by a neutral third party known as an EAT (Exchange Accommodation Titleholder) until the construction is complete and the deed can be transferred.

## **Resources**

### ***Federation of Exchange Accommodators (FEA)***

The FEA is a professional trade association of Qualified Intermediaries that provides a wealth of information on the benefits of using an intermediary as well as a search engine to help you locate a QI member in your area. Visit their Web site at [www.1031.org](http://www.1031.org).

### ***National Association of Realtors (NAR)***

The largest and most respected real estate organization in the country, the NAR's Web site has a wealth of information on like-kind exchanges. Their "Field Guide to 1031 Exchanges" can be found at <http://www.realtor.org/libweb.nsf/pages/fg408>.

### ***Internal Revenue Service***

Learn the ins and outs of 1031 exchange regulations straight from the source. Visit the IRS Web site at

<http://www.irs.gov/businesses/small/industries/article/0,,id=98491,00.html>.

### ***Tax Savings Calculators***

Determine how much a 1031 may save you on capital gains taxes with one of the

following online calculators:

<http://www.allstates1031.com/capital-gains-calculator.php>

[http://www.1031x.com/tax\\_calculator.cfm](http://www.1031x.com/tax_calculator.cfm)

[www.1031exchangeoptions.com/calculator.html.](http://www.1031exchangeoptions.com/calculator.html)

## SECTION 5

# 6 RULES YOU NEED TO KNOW ABOUT 1031 EXCHANGES

**Don't let the IRS deadlines stop your 1031 exchanges.**

- 1. Real Property Use** - Both your OLD and NEW properties must qualify as investment or business use. (Nearly all types of Real Estate qualify.)
- 2. 45 Day Identification period** - You have 45 days from the closing of your sale to list the properties you may want to buy. There are no exceptions to this deadline.
- 3. 180 Day Exchange period** - From the sale closing date, you only have 180 days to close on one or more of the properties from your 45 day list.
- 4. Qualified Intermediary** - The IRS mandates that you use a QI to prepare the legal documents for your exchange. The QI also holds the money till you exchange is complete.
- 5. Proper Title Holding** - You must purchase and take title to your new property exactly as you held title to your old property.
- 6. Reinvestment Requirement** - To defer all of your capital gain tax, you must buy a property equal or higher in value than the one you sold. You must reinvest all of the cash proceeds from your sale.

## **SECTION 6**

### GLOSSARY OF COMMON 1031 EXCHANGE TERMS

#### **1031**

A section of the Internal Revenue Code that provides for tax deferral on like-kind exchanges of real and personal property held for use in a trade or business.

#### **1031 Exchange**

A type of exchange sanctioned by IRC Section 1031 that allows taxpayers who sell real or personal property (relinquished property) and purchase like-kind real estate or personal property (replacement property) to defer capital gains taxes if certain requirements are met.

#### **Accelerated Depreciation**

A depreciation method in which a greater portion of the cost of depreciable property is deducted in the first years after the property is placed in service, as opposed to spreading it out over a longer period of time.

#### **Accommodator**

Another word for Qualified Intermediary (QI). It is a neutral third party in a like-kind exchange who oversees the transaction, including managing the proceeds of the taxpayer's relinquished property and the acquisition of the taxpayer's replacement property. An Accommodator is often known as a facilitator or intermediary.

#### **Adjusted Cost Basis**

This is a dollar amount used to determine a capital gain or loss following the sale of property. It is usually calculated by taking the original purchase cost, adding the cost of improvements and other expenses, and then subtracting depreciation and casualty losses taken.

#### **Boot**

Cash or property received in an exchange that is subject to capital gains taxes. See also Mortgage Boot.

#### **Build-To-Suit Exchange**

A like-kind exchange in which an intermediary holds title to the replacement property on behalf of the taxpayer while improvements are made to the property. Also known as a Construction Exchange.

#### **Capital Gain or Loss**

The difference between the selling price of property and its adjusted cost basis.

#### **Capital Gains Tax**

Government taxes imposed on investment gains.

#### **Constructive Receipt**

Taxpayer access to or control of proceeds involved in an exchange transaction. Taxpayers in constructive receipt of funds during an exchange are ineligible for 1031 exchange status.

**Deferred Exchange**

The most common type of like-kind exchange involving first the sale of relinquished property followed by the purchase of replacement property, all within the time limitations allowed by law. Also known as a Starker Exchange or Forward-Delayed Exchange.

**Direct Deeding**

Deeding of property from one party to another without the use of a Qualified Intermediary.

**Equity**

The value of a person's ownership in property.

**Exchange Accommodation Titleholder (EAT)**

A neutral third party that holds title to either the replacement or relinquished property during the course of an exchange.

**Exchange Agreement**

A written agreement between a taxpayer and a Qualified Intermediary or Accommodator setting out the duties and responsibilities of both parties during an exchange transaction.

**Exchange Period**

The period of time in a like-kind exchange during which the exchanger must finalize acquisition of replacement property. The exchange period is 180 days from the sale of relinquished property OR the exchanger's tax-filing due date for the year the property was exchanged. For late-year exchanges, this often means less than 180 days (unless a tax filing extension is sought).

**Exchanger**

A taxpayer involved in a tax-deferred like-kind exchange transaction. Individuals, partnerships, businesses and corporations can all act as exchangers.

**Excluded Property**

Any property (real or personal) not eligible for use in a like-kind exchange. Such property includes, but is not limited to, that held for personal use (such as homes, boats or cars); cash; dealer inventory; stocks, bonds, notes and other securities; and partnership interests.

**Forward-Delayed Exchange**

See Starker Exchange and Deferred Exchange.

**Identification Period**

The period of time in an exchange during which an exchanger must formally identify potential replacement properties. This period is 45 calendar days from the sale of the exchanger's relinquished property.

**Intermediary**

A general term used for Accommodators and Qualified Intermediaries (QI).

**Like-Kind Exchange**

An exchange of real estate or personal property held for business or investment use for property that is like-kind according to Internal Revenue Code Section 1031. Capital gains from such exchanges are not taxed until the replacement property is sold.

**Like-Kind Property**

Property considered exchangeable for other property in a tax-deferred exchange (i.e., investment real estate for investment real estate or personal property for personal property).

**Mortgage Boot**

In a like-kind exchange, this is the difference between the debt owed on the relinquished property and the replacement debt. If the replacement mortgage is less than the original mortgage, capital gains taxes must be paid on the difference.

**Multi-Asset Exchange**

An exchange involving more than one type of asset, such as personal property and real estate.

**Personal Property**

In a like-kind exchange, personal property is generally considered that which can be moved. Examples include machinery, equipment, vehicles and furniture.

**Qualified Exchange Accommodation Agreement**

An agreement that details the terms of the exchange transaction as well as the responsibilities of both the intermediary and the taxpayer. Such an agreement provides the taxpayer Safe Harbor from IRS infractions.

**Qualified Intermediary**

A neutral third party used in a like-kind exchange to act as a facilitator (or Accommodator) throughout the transaction. Common duties include holding and managing property sale proceeds, preparing legal documentation, advising and consulting with the exchanger, and ensuring that all Internal Revenue Code regulations are met.

**Qualified Use**

A term referring to a property's intended function in a like-kind exchange. Only those properties that pass the qualified-use test (meaning that they are purchased only for their investment or business value) are eligible for tax-deferred status.

**Real Property**

In general, real property includes property that is immovable, such as real estate and various types of ownership interests in real property. Some examples are raw land, buildings (apartment and commercial buildings, factories and warehouses, shopping centers, and condominiums), leases of 30 years or more, quarries and oil fields. Real property is exchangeable for other real property in a like-kind exchange. In general, state laws determine what constitutes real property.

**Relinquished Property**

The property to be sold or disposed of by the exchanger in the tax-deferred, like-kind exchange transaction.

**Replacement Property**

The property being acquired by an exchanger in a tax-deferred like-kind exchange.

**Reverse Exchange**

An exchange transaction whereby the replacement property is acquired before the sale of the relinquished property. Reverse exchanges are generally more complex and therefore more costly to transact.

**Safe Harbor**

A provision provided by Treasury Regulations that excuses liability if the attempt to comply in good faith can be demonstrated. In reference to like-kind exchanges, this usually involves the Constructive Receipt requirement. Exchangers who work with Qualified Intermediaries are automatically granted Safe Harbor.

**Simultaneous Exchange**

An uncommon form of like-kind exchange whereby the relinquished property and the replacement property are transferred at the same time.

**Starker Exchange**

Another name for a Deferred Exchange or Forward-Delayed Exchange. It is named for the landmark *Starker v United States* case in 1979 that sanctioned the extended timeframe for purchasing replacement property and led to important 1031 tax code changes in the Tax Reform Act of 1984.

**Tax Deferral**

The postponement of taxes to a later year, usually by recognizing income or a gain at a later time. Tax-deferred, like-kind exchange transactions are a common method of deferring capital gain and depreciation recapture taxes.

**Tenancy in Common**

A form of joint ownership in which individuals purchase separate fractional interest in a property and have equal rights of possession. In a 1031 exchange, a taxpayer may acquire a tenancy-in-common interest with one or more other investors as like-kind replacement property.