

# 1031 EXCHANGE

Here at The Wealthy Daughter, we know that true success starts in the mind...that's why we put so much emphasis on knowledge.

This article regarding **1031 Exchanges** is meant to give you knowledge. It is to answer that age old problem "I don't know...what I don't know". This is not meant to take the place of the professional team you will need to successfully complete a 1031 Exchange. We seek competent legal, financial and tax counsel prior to entering into any 1031 tax-deferred, like-kind exchange.

## Overview...

In 1921 the Internal Revenue Code (IRC) introduced a vehicle for deferring capital gain taxes while disposing of investment properties. Thanks to IRC 1031, a properly structured exchange now allows an investor to sell a property, to reinvest the proceeds in a new property and to defer all capital gain taxes.

The theory is that when you have 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, your 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 you to pay tax on a "paper" gain.

We are talking tax-deferred, not tax-free. When the replacement property is ultimately sold, the original deferred gain, plus any additional gain realized since the purchase of the replacement property, is subject to tax. Meanwhile, however, you are able to leverage the dollars you would have paid in taxes.

One of the first things we need to get out of the way is that this "exchange" is known by many different names: Starker exchanges, delayed exchanges, like-kind exchanges, 1031 exchanges, section 1031 exchanges, tax-free exchanges, nontaxable exchanges, real estate exchanges, or real property exchanges. The key word is "exchange". You are "exchanging" one property for another. Sales are taxable with the IRS - a

1031 exchange is not. Since you are not selling you qualify for a deferred tax gain.

The following simple example helps to understand this powerful wealth building tool. In both examples we will assume a 25% down payment and a 75% loan to value ratio.

**Sale of a property** - An investor has a \$200,000 capital gain and incurs a tax liability of approximately \$70,000 in combined taxes (depreciation recapture, federal and state capital gain taxes) when the property is sold. Only \$130,000 remains to reinvest in another property. The seller would only be able to purchase a property worth \$520,000.

**Exchange of a property** - In an exchange, the total \$200,000 would be used as a down payment. The seller would be able to purchase a property worth \$800,000.

The next term that confuses new investors is "**like-kind**". "Like-kind" does not mean the exact same kind - for example bare land exchanged with bare land. The actual definition of "like-kind" is far more flexible. Any real property held for investment or real property used in a trade or business can be exchanged for any other real property held for investment or real property used in a trade or business. Let's look at some examples:

<b>Relinquished Property</b>	<b>Replacement Property</b>	<b>Benefit</b>
Non-income producing land	Triple net leased property	Cash flow
Multiple rentals	Single use commercial	Easier to manage
Offices	Industrial and apartments	Diversification

## Type of Exchanges:

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1. **The Delayed Exchange** – this is the most common of all the exchanges. It provides investors with the flexibility of up to a maximum of 180 days to purchase a replacement property.
2. **The Simultaneous Exchange** – these two-party trades (“swaps”) and complicated three party exchanges (require either buyer or seller to act as the “accommodating party”) are rare due to the timing difficulty, liability risks and potential complication.
3. **The Improvement Exchange** – the improvement (build-to-suit or construction) exchanges allow an investor to use exchange proceeds to either make improvements or build a new replacement property. This variation is popular because it provides the opportunity to purchase properties needing renovation or acquire bare land and build to an investor’s exact specification. It is key to know that the improvements must be done in the 180 exchange period so careful advance planning is essential. This includes permits, construction delays, etc. You are not permitted to build on property you already own. Therefore, an unrelated party or parking entity must take title to the replacement property, make the improvements, and convey title to you before the end of the exchange period.
4. **The Reverse Exchange** –sometimes called a “parking arrangement,” occurs when you acquire a Replacement Property before disposing of your Relinquished Property. A “pure” reverse exchange, where you own 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. You will want to talk with your tax advisor and attorney when participating in this type of exchange.
5. **The Personal Property Exchange** – This is different than those stated above. The “like-kind” or “like-class” or personal property exchange must be in the same “General Asset Class” or the same “Product Class.” For example, a business aircraft must be exchanged for another business aircraft, or restaurant equipment may be exchanged for similar equipment.
6. **The Multi-Asset Exchange** – the multi-asset exchange isn’t really considered a formal type of exchange but it begs talking about as this type 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 you want to exchange the hotel for a similar property, you 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 you to enjoy the benefits of an exchange for the entire relinquished property, not just for the real estate portion.

**The Napkin Rule** - You must buy a Replacement Property of equal or greater value to the Relinquished Property in order to completely defer the applicable capital gains tax. If you purchase a property of lesser value, you will be responsible for any tax on the difference. You must use all the cash proceeds from the sale on your purchase in order to completely defer the applicable capital gains tax. Now if you happen not use all your proceeds on the purchase, you will be responsible for any tax on the difference.

To fully defer all capital gain taxes, you must meet two requirements;

Reinvest all exchange proceeds – if you do not reinvest all exchange proceeds from the sale of the relinquished property, the balance received is considered “cash boot” and gain may be recognized on that amount.

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Acquire property with the same or greater debt – if you have a reduction in debt the reduced amount is taxable.

Review the following two examples:

Example 1	Sale	Purchase	Boot
Sale Price	\$450,000	Purchase Price	\$600,000
Minus Debt	-\$200,000	New Debt	\$380,000    0
Minus Cost of Sale	-\$ 30,000		
Exchange Proceeds	=\$220,000	Down Payment	\$220,000    0

Example 2	Sale	Purchase	Boot
Sale Price	\$450,000	Purchase Price	\$360,000
Minus Debt	-\$200,000	New Debt	\$160,000    \$40,000
Minus Cost of Sale	-\$ 30,000		
Exchange Proceeds	=\$220,000	Down Payment	\$200,000    \$20,000
Total Boot			\$60,000

Notice: In example 2 the purchase price was less and the debt was \$160,000 which is \$40,000 less than it was in the property being sold. This puts \$40,000 in the mortgage boot. In addition, only \$200,000 of the \$220,000 net equity was invested leaving \$20,000 in the cash boot. The \$60,000 (\$40,000+\$20,000) in boot is taxable.

**Boot** - is any property you receive in the exchange which is not like-kind to the relinquished property. In the above example both the “mortgage” and “cash” boot are represented. The mortgage boot (\$40,000) and a cash boot (\$20,000). Realized Gain is the increase in your economic position as a result of the exchange - in this case the net boot (\$60,000) is received.

Recognized gain would be any (boot) non like-kind property received: Let’s say you received \$4,000 cash + \$6,000 vehicle = \$10,000 of boot received. Recognized gain is equal to the lesser of (1) amount of boot

received, but not to exceed (2) the total realized gain. Since there was \$60,000 in realized gain, and \$10,000 in boot, the \$10,000 in boot is the recognized gain and considered taxable gain.

**Qualified Intermediary (QI)** - This person is an independent party who facilitates tax-deferred exchanges pursuant to Section 1031 of the Internal Revenue Code. The QI cannot be you or a disqualified person. You also should not go to a settlement unless your Qualified Intermediary’s document is at settlement.

The Qualified Intermediary:

- Acts under a written agreement with you, the seller, the QI acquires the relinquished property and transfers it to the buyer.
- Holds the sales proceeds, to prevent you from having actual or constructive receipt of the funds.
- Acquires the replacement property and transfers it to you to complete the exchange within the appropriate time limits.

Let’s stop a minute and discuss who is considered a “disqualified” person - this is any one who has a relationship with you that is so close that the person is presumed to be under your control. 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.

Your relationship ends with the Qualified Intermediary the moment you have 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 you meet the requirements of this safe harbor, the IRS will not consider you 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. A word of caution. Yes, you could use a friend to hold the money, but...this is the time to pay a professional to work through this with you as they will also be

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familiar with the regulations and keep you from falling into non-compliance.

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

**Timelines** - If you have already signed the contract and then decide to start a tax-deferred exchange you may do so, as long as you have not transferred title, or the benefits and burdens of the relinquished property. Once the closing occurs, it is too late to take advantage of a Section 1031 tax-deferred exchange (even if you have not cashed the proceeds check).

There are 2 timelines that anyone going for a *1031 property exchange* or (TIC) should abide by and know.

**The Identification Period:** This is the crucial period during which the party selling a property must identify other replacement properties that she proposes or wishes to buy. It is not uncommon to select more than one property. This period is scheduled as exactly 45 days from the day of selling the relinquished property. This 45 day timeline must be followed under any and all circumstances and is not extendable in any way, even if the 45th day falls on a Saturday, Sunday or legal US holiday.

**The Exchange Period:** This is the period within which a person who has sold the relinquished property must receive the replacement property. It is referred to as the Exchange Period under *1031 exchange (IRS) rule*. This period ends at exactly 180 days after the date on which the person transfers the property relinquished or the due date for the person's tax return for that taxable year in which the transfer of the relinquished property has occurred, whichever situation is earlier. According to the 1031 exchange (IRS) rule, the 180 day timeline has to be adhered to under all circumstances and is not extendable in any situation, even if the 180th day falls on a Saturday, Sunday or legal (US) holiday.

Unfortunately as you can see there are no extensions available. If you do not meet the

time limits, the exchange will fail and you 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)*.

**Identifying your next property** - There are three rules that limit the number of properties that can be identified. You must meet the requirements of at least one of these rules:

- ◆ **3-Property Rule:** You may identify up to 3 potential replacement properties, without regard to their value. We recommend that you identify 3 properties as it doesn't cost anything and it gives you room if you come up with a surprise inspection, etc. You do need to take this seriously as you have to choose one of these three properties or you will be back at square one without a property.
- ◆ **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.

Potential replacement properties must be identified in writing, signed by you, and delivered to a Qualified Intermediary. The identification cannot be made orally.

**Your team** – you should do advanced planning with any exchange. Your team should include your accountant, attorney, real estate broker, financial planner, lender and Qualified Intermediary.

**Read, read, read** – Read the IRS form 8824 before you start the exchange. This form will clarify what you have learned.

**Partnership** – this is not the time to change any partnerships or manner of holding title as this may jeopardize the exchange.

**Taxes** - do not file your income taxes for the year in which you do your exchange until you completed your exchange. If you do

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you could lose the benefits of the exchange. Also, be sure to acquire property with equal or greater debt because unless the debt reduction is replaced with cash, you pay tax on the debt reduction and you have no funds from the exchange with which to pay the tax.

**Other Misc items** – Only real “like-kind” property qualifies as replacement property...so do not buy a real estate mutual fund or an REIT (Real Estate Investment Trust) planning to do an exchange.

Foreign investment properties do not qualify, only those within the U.S. or U.S. Virgin Islands.

**Cooperation Clause** – If the property qualifies you will need to include a cooperation clause in the listing agreement. A cooperation clause establishes intent. Here is an example:

“Buyer hereby acknowledges that it is the intent of the Seller to effect an IRS Section 1031 tax-deferred exchange which will not delay the closing or cause additional expenses to the Buyer. The Seller’s rights under this agreement may be assigned to a Qualified Intermediary, named by the Seller, for the purpose of completing such an exchange. Buyer agrees to cooperate with the Seller and the Qualified Intermediary in a manner necessary to complete the Exchange.

## Terms and Definitions

**1031 Exchange** - 1031 Tax Deferral permits taxpayers to reinvest the proceeds from the sale of property held for investment or business purposes into another investment or business property, and defer capital gains tax that would otherwise be due on the initial sale.

**Adjusted Basis** - The original basis plus any improvement costs minus the full depreciation on the property.

**Agreement for Transfer** - Purchase agreement, offer and acceptance, sale agreement, earnest money agreement, real

estate contract or other contract contemplating the purchase or sale of real property.

**Boot** - This the property the taxpayer receives in the exchange which does not qualify as “like kind” property. Cash proceeds are the most common form of boot and a boot is subject to taxation.

**Capital Gain** - The capital gain is calculated as follows: total selling price of the relinquished property, less exchange expenses, less the relinquished property’s adjusted basis. The adjusted basis is the original cost, plus the cost of capital improvements, less depreciation or cost recovery deductions. Capital gains may be subject to depreciation recapture and other rules of the IRS.

**Construction 1031 Exchange** - You may purchase replacement property that is not yet built, provided that the improvements on the property are completed prior to the expiration of the 180 days (Which can be very difficult). In a Construction 1031 Exchange, the property is held by a specially formed LLC called the EAT “Exchange Accommodation Taxpayer”. A Construction Exchange generally has greater complexity and fees than a 1031 Exchange.

**Constructive Receipt** - This is a term that refers to the 1031 exchanger having unrestricted control of the equity from the property sold and a Constructive Receipt will invalidate a tax deferred 1031 exchange.

**Contract 1031 Exchange** - A “Contract Exchange” is the tax-deferred exchange of: The Buyer’s ownership in a Sales Contract on real property, for different real property, or for a contract or option on different real property; or the Option Holder’s exchange of an Option to purchase real property, for different real property, or for an option or contract on different real property. Essentially, a “contract exchange” is a 1031 exchange of an open option to purchase, or an open Sales Contract, rather than a 1031 exchange of the underlying real estate itself.

**Cooperation Clause** - A clause that is added to the purchase on sales agreement

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requiring the person who is not the exchanger to use their best efforts to assist the exchanger in consummating a 1031 tax deferred exchange.

Exchange Accommodation Taxpayer - The Exchange Accommodation Taxpayer "EAT" is a specially formed LLC used during a Construction Exchange or a Reverse Exchange.

Exchanger - The actual owner of the investment property looking to make a tax deferred exchange. Unfortunately an exchanger cannot be an owner that wishes to defer capital gains tax on a second home. See "like kind" property definition.

Exchange Funds Account - The account established by the qualified intermediary (QI) to hold the exchange funds.

Exchange Period - A 180 day window in which the exchanger has to complete a tax deferred exchange. During the exchange period there is a 45 day identification period in which the exchanger must identify which property or properties that will be purchased.

The Fair Market Value - This is likely selling price as defined by the market at a specific point in time.

Forward Delayed Exchange - A type of exchange which occurs when a property is sold "Relinquished Property" and another property is purchased "Replacement Property" within 180 days following the sale of the Relinquished Property.

Identification Period - The time period that begins upon the "close of escrow" of the relinquished property. During this 45-day period, the 1031 exchanger must identify the replacement property in order to continue with the section 1031 exchange transaction.

Identification Removal - An Identification Removal form is used to remove previously identified Replacement Property or properties within the Identification Period of 45 days.

Identification Statement - An Identification Statement form is used to identify potential replacement property or properties

IRS 1031 Tax Code - Internal revenue code section 1031.

"Like-Kind" Property - The properties involved in a tax deferred exchange must be similar in nature or characteristics. "Like kind" real estate property is basically any real estate that is NOT your personal residence or NOT a second home.

The Napkin Rule - You must buy a Replacement Property of equal or greater value to the Relinquished Property in order to completely defer the applicable capital gains tax. If you purchase a property of lesser value, you will be responsible for any tax on the difference. You must use all the cash proceeds from the sale on your purchase in order to completely defer the applicable capital gains tax. If you happen not use all your proceeds on the purchase, you will be responsible for any tax on the difference.

Original Basis - This is the purchase price of a property and it is used to calculate capital gains or losses for tax purposes

Personal Property - Any property belonging to the 1031 exchanger that is non real estate related.

Phase 1 - The process in which the relinquished property is sold and all of the respective paper work for that process is completed. This process is also known as the "down leg" of the tax deferred exchange process.

Phase 2 - This is the process in which the replacement property is bought and all the respective paperwork for that process is completed. This process is also known as the "up leg" of the tax 1031 deferred exchange process.

Qualified Intermediary - The Intermediary is also known as, QI, Accommodator, Facilitator, Qualified Escrow Holder. A third party that helps to facilitate the exchange.

Real Estate Exchange - A type of Exchange of real property for real property. All types of real property are "like kind" for other real property, including vacant land, residential,

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commercial, and even some long term leases.

Relinquished Property - The original property being sold by the taxpayer when making a 1031 exchange.

Replacement Property - Is the new property being acquired by the taxpayer when making a 1031 exchange.

Reverse Exchanges - This is the type of exchange in which the Replacement Property is purchased before the sale of the Relinquished Property.

Rules of Identification - The guidelines that must be followed when making a 1031 tax deferred exchange, such as the 3 Property Rule, 200% Percent Rule, and 95% Percent Rule.

Settlement Agent - Definitions include: Title agent, closing officer, escrow officer, settlement officer, closing agent, closing attorney, settlement attorney.

Tax Advisor - Financial Advisor, Accountant, CPA, Tax attorney.

Taxpayer - Client, investor, or the exchanger.

Tax Deferred Exchange - The procedure outlined under IRS Code Section 1031 involving a series of rules and regulations that must be met in order to take full advantage of deferring capital gains tax on the sale of investment real estate. 1031 tax-deferred exchanges are also commonly known as: Starker exchanges, delayed exchanges, like-kind exchanges, 1031 exchanges, section 1031 exchanges, tax-free exchanges, nontaxable exchanges, real estate exchanges, real property exchanges. Though all of these terms refer to the same thing, the most typical term used today is the tax deferred 1031 exchange.

Tenancy In Common (TIC) - A fractional or partial ownership interest in a piece of property, rather than owning the entire piece of property.

Three Property Rule - The Exchanger may identify up to 3 properties, without regard to their value.

The 200% Percent Rule - The 1031 Exchanger may identify more than three properties, provided their combined fair market value does not exceed 200% of value of the Relinquished Property.

The 95% Percent Rule - The 1031 Exchanger may identify any number of properties, without regard to their value, provided the Exchanger acquires 95% of the fair market value of the properties identified.

I will finish this article with a reminder: - Talk with your legal team before you start. The intent of this article is to increase your knowledge of 1031 Exchanges. It is a solution to that problem "but I don't even know where to start". It is not intended or should it take the place of your legal team.

Warmly,

Sharlet Briggs  
The Wealthy Daughter