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The Basics of 1031 Exchange

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What is a 1031 Exchange?

The Internal Revenue Code provides that a taxpayer may sell property and defer payment of any capital gains tax if that taxpayer uses the proceeds to acquire “like kind” replacement property.

Section 1031 of the Code states:

No gain or loss shall be recognized 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.

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What is a 1031 Exchange?

In order to qualify for this tax treatment (i.e. deferring payment of capital gains tax), the IRS requires that specific rules be followed by the taxpayer when engaging in an exchange of property for other like-kind property.

Those rules are set forth in the 1991 Treasury Regulations issued by the IRS.

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Why Exchange?

- Capital gains tax is fairly substantial;
- Reinvestment into replacement property allow exchanger to leverage dollars that would otherwise be spent on taxes;
- Transfer to income producing property;
- Diversify and minimize risk to real estate portfolio

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What is Capital Gain?

When a taxpayer sells property and has a “gain”, that gain is capital gain that is subject to taxation.

Gain IS **NOT** profit. One can have a profit, but have no gain whatsoever.

Capital Gains Tax Rates

- 20% federal plus state
(e.g. CA's highest marginal rate is 10.3%)

- 25% on gain attributable to depreciation

- Ordinary income tax rates apply to excess depreciation

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How to Determine Capital Gain

- How do you determine “taxable gain” or “capital gain”??
- Selling price minus Adjusted basis = capital gain
- Adjusted Basis = Basis (the amount you originally purchased the property for) <u>plus</u> the amount paid to make improvements to the property <u>minus</u> depreciation taken

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1031 Exchange—Basic Rules

Rule #1: Property being sold and property being acquired must both be "held for investment purposes (i.e. for appreciation in value; for rent; for business use). Primary Residences cannot be exchanged under 1031.

Rule #2: The taxpayer/exchanger MUST use the services of a Qualified Intermediary (i.e. "QI" -- that's us); OR a Qualified Trust; OR a Qualified Escrow Account to handle the transaction. (1 exception: a true swap – i.e. A gives property to B and B gives property to A – equally valued)

Rule #3: The taxpayer/exchanger cannot actually or constructively receive proceeds from the sale or the transaction will be disqualified.

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1031 Exchange—Basic Rules

Rule #4: The taxpayer must enter into an Exchange Agreement on or before the date of transfer of the Relinquished Property.

Rule #5: The taxpayer must identify – in writing – potential properties that will be the replacement property in the exchange. The Treasury Regulations require that this written identification must be made in a certain manner. Also, the Treasury Regulations required that it be done within 45 days following close of escrow for the sale of the Relinquished Property. And, the rules limit the number of properties the taxpayer may identify as potential replacement properties (See Separate Slide on "Identification")

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1031 Exchange—Basic Rules

Rule #6: The taxpayer may not have access to any of the exchange proceeds during the exchange period. See separate slide re: Restrictions on Access to Exchange Proceeds.

Rule #7: The taxpayer must complete the acquisition of one or more of the "identified properties" within 180 days from the sale of the RQ property or the due date of the tax return for the year in which the RQ sold. This is the "Exchange Period".

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1031 Exchange—Basics

Terms

Relinquished Property = property being sold

Replacement Property = property being acquired

Identification Period = 45 day period following close of sale of RQ in which taxpayer is required to list – in writing – potential replacement properties.

Exchange Period = 180 day period following close of sale of RQ in which taxpayer must complete the acquisition of the replacement property (ies).

(g)(6) Restrictions = Specific section of the IRS Treasury Regulations that states when an exchanger is entitled to receive proceeds.

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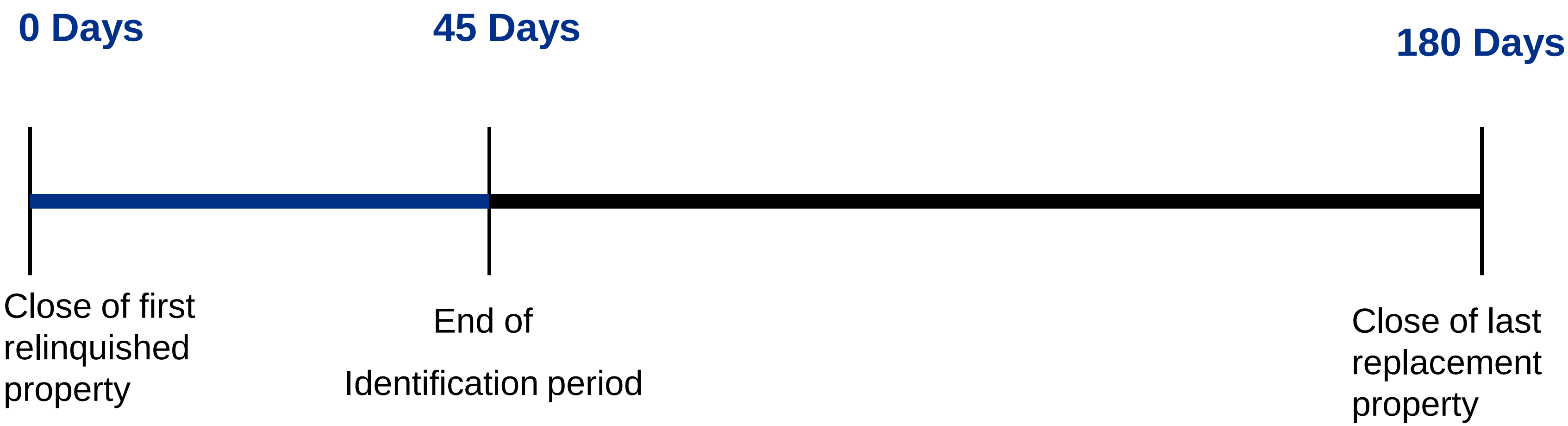
Delayed Exchange Timeline



<u>45th day</u> ends at midnight on the 45th day after the date the exchanger transfers the RQ (e.g. RQ close on 9/12, 45th day calculation begins on 9/13)

<u>180th day</u> ends on midnight of the 180th day after the date the exchanger transfers the RQ (e.g. RQ closes on 9/12, 180th day calculation begins on 9/13)

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Rules of Identification

- **3-Property Rule:**
  - Up to 3 properties of any value
- **200% Rule:**
  - Any number of properties as long as the FMV does not exceed 200% of the RQ
- **95% Exception:**
  - Can still qualify if acquire 95% of the value of all of the properties identified

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Identification

Proper Format

- must in writing
- must be sent to the intermediary, the person obligated to transfer the RP (even if otherwise disqualified) or other party involved in the exchange (as long as they are not disqualified) on or before 45 days
- must be dated
- must be signed by all taxpayers involved in the exchange
- must be revoked in the same manner that it is made

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When can the Exchanger receive proceeds?

The (g)(6) Restrictions

Exchanger may receive Exchange Proceeds from Intermediary only upon the following occurrences:

A. After the expiration of the 45 day Identification Period, if Exchanger failed to identified Replacement Property by

OR

B. After the expiration of the 45 day Identification Period, if Exchanger has identified Replacement Property (pursuant to paragraph 6) and there has occurred after the end of the Identification Period, a material and substantial contingency that (1) relates to the deferred exchange, (2) is provided for in writing, and (3) is beyond the control of the Exchanger and of any disqualified person, as defined in Treasury Regulations Section 1.1031 (k)(2), (k)(3) or (k)(4), other than the person obligated to transfer the Replacement Property to Exchanger.

OR

C. Any time – if -- the Exchanger has received all of the property to which they are entitled to under the Exchange Agreement.

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How does the exchange work?

- Exchanger enters into contract to sell property. The contract should indicate an intent to sell the property as part of a 1031 tax deferred exchange.
- Exchanger assigns contract to QI. Written notice of the assignment must be given to the buyer on or before the date of the transfer otherwise the exchange will fail. Absent notice of the assignment, exchanger will be treated as if they transferred the property direct to the purchaser without a QI.
- QI then participates in the sale as the seller and signs all documents for transfer of the property to the buyer.
- All proceeds are distributed to QI to hold for purchase of replacement property
- During the exchange period, there are substantial restrictions on the exchanger's access to the exchange proceeds. In short, the exchanger may not have actual or constructive receipt of the proceeds. Pledging, borrowing or otherwise hypothecating the exchange proceeds is the equivalent of "constructive receipt". Retention of funds by the escrow agent after close of escrow may also be deemed "constructive receipt".
- Exchanger must – within 45 days – identify in writing the intended property to be acquired.
- Exchanger enters into a contract with the seller of the replacement property.
- Exchanger assigns the contract to the QI.
- QI uses the exchange proceeds to purchase the RP.

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What We Do

•Act as “Qualified Intermediary” as required by the Treasury Regulations (this means that we acquire the RQ from the exchanger and transfer it to the buyer and we acquire the RP and transfer it to the exchanger);

•Prepare all documents required for the exchange (e.g. Exchange Agreement; Assignment of Sales Contract for RQ; Assignment of Sales Contract for RP)

•Consult with exchanger’s tax advisor

•Execute closing documents as principal (as Seller in the RQ closing and as Buyer in the RP closing)

•Hold exchange proceeds to prevent exchanger from either actual or constructive receipt of the funds;

•Coordinate with closing agents, real estate agents, tax and legal advisors.

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Property Excluded From 1031 Treatment

(A) stock in trade or other property held primarily for sale,

(B) stocks, bonds, or notes,

(C) other securities or evidences of indebtedness or interest,

(D) interests in a partnership,

(E) certificates of trust or beneficial interests,

(**F)** Chooses in action

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Three general requirements for tax deferral under §1031

1) both the property surrendered and the property received must be held either for productive use in a trade or business or for investment;

2) the property surrendered and the property received must be of "like-kind;" and

3) there must be an exchange as distinguished from a sale and a purchase.

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4 Methods of Exchanging

1) **Delayed Exchange:** Sell Relinquished Property ("RQ") and, within 180 days thereafter, complete the purchase of Replacement Property ("RP").

2) **Simultaneous Exchange:** Sell RQ simultaneous with the purchase of RP

3) **Reverse Exchange:** Purchase of RP occurs before sale of RQ (sale of RQ must occur within 180 days of the purchase of the RP)

4) **Construction or "Improvement" Exchange:** Sell RQ, use exchange accommodation titleholder to acquire and hold RP while proceeds used to construct improvements. Upon completion of improvements, RP conveyed to exchanger.

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What is "like-kind?"

Any property that is "held for investment" or "for use in a trade or business".

Examples of like-kind real property:

- Raw land for a shopping center
- Apartment building for shopping center
- Fee interest in shopping center for 30+leasehold in industrial building (when calculating the 30 yr requirement – options are included)
- Hotel for farm

Examples of like kind personal property:

- Livestock of the same sex
- Dental equipment for dental equipment
- Tractors for tractors
- Automobiles for automobiles

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How long must a property be held to meet the "Qualified Use" requirement?

i.e. "held for investment"

There is no magical time period. The letter rulings and case law are varied with respect to factors relied upon by the IRS and courts in determining whether a taxpayer has "held property for investment". Most important, the intention to hold the property must be present at the time the property is acquired.

- See Bundren v. Commissioner, T.C. Memo 2001

  (Exchange succeeded: property held for investment only 4 months before disposition)

- See also S.H. Klarkowski, 24 T.C.M. 1827 (1965), aff'd on other grounds, 385 F.2d 398 (7th Cir., 1967),

  (exchange failed: property held for 6 years)

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What is "Boot?"

Boot is anything that the taxpayer receives in an exchange that is not like kind to the property traded in the exchange.

A taxpayer will be taxed on any boot received *up to the amount his gain*.

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Related Party Exchanges

Selling Property to a Related Party:

A taxpayer may sell relinquished property to a related party. However, there is a 2 year holding requirement imposed by IRS Section 1031(f). Specifically, the related party must continue to hold the relinquished property for 2 years <u>and</u> the taxpayer must hold the replacement property for 2 years, otherwise the taxpayer's exchange will fail.

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Related Party Exchanges

Buying Property from a Related Party: A taxpayer may purchase replacement property from a related party only if the related party seller completes an exchange. Additionally, the taxpayer and the related party must thereafter hold their respective replacement properties for a period of 2 years. Note: an acquisition will be treated as a related party acquisition if the replacement property was– within 2 years preceding the taxpayer's acquisition owned by a related party.

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Benefits of a 1031 Tax Deferred Exchange

- Defer Capital Gains Tax
- Leverage for Wealth Building
- Relocate Assets
- Minimize Time and Effort
- Estate/Tax Planning

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Potential Hazards in a 1031 Tax Deferred Exchange

- Vesting
- Marital
- Partnership Interests
- Carry-back Financing
- Repair Work
- Related Parties
- Non Exchange-Related Costs
- Holding Requirement

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Selecting an Intermediary

- Financial Security **
- Compliance with IRC §1031
- Experience

** OREXCO's parent company, Old Republic International, has 15.8 billion in assets; OREXCO has a $50 million errors & omissions policy and a $80 fidelity bond covering acts of dishonesty or fraud.

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