USING IRC SECTION 1031 TO CREATE AND PRESERVE WEALTH

A SECTION 1031 EXCHANGE IS THE MEANS BY WHICH ONE CAN DEFER CAPITAL GAINS TAXES ON THE SALE OF PROPERTY HELD FOR INVESTMENT OR PRODUCTIVE USE- BY EXCHANGING THAT PROPERTY FOR OTHER "LIKE-KIND" PROPERTY HELD FOR INVESTMENT OR PRODUCTIVE USE.

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WHAT IS A TAX DEFERRED EXCHANGE?

A tax-deferred exchange is simply a method by which a property owner trades one property for another without having to pay any federal income taxes on the transaction. In an ordinary sale transaction, the property owner is taxed on any gain realized by the sale of the property. But, in an exchange, the tax on the transaction is deferred until some time in the future, usually when the newly acquired property is sold. Most investors will continue to exchange, therefore continue to defer the accumulating tax.

Tax deferred exchanges are authorized by Section 1031 of the Internal Revenue Code. The requirements of Section 1031 and other sections must be carefully met, but when an exchange is done properly, the tax on the transaction may be deferred.

In an exchange, a property owner simply disposes of one property and acquires another property. The transaction must be structured in such a way that it is in fact an exchange of one property for another, rather than the taxable sale of one property and the purchase of another.

Much of the history of exchanging has been developed from the courts either accepting or rejecting the use of exchanges. Over a period of seventy years a considerable body of law has been created. Tax reform measures 1984, 1986, 1989, 1990 and 2000, have helped shape the current provisions for today's 1031 regulations. The 1991 Regulations presented a detailed process or method for identifying replacement property in a deferred exchange, time limits were defined and explained, the deferred exchange was defined and a special rule was provided for improvements to be built as replacement property. In October 2000, procedures were issued for reverse exchanges removing concerns about the legitimacy of reverse exchanges.

"Safe Harbors" were established to define acceptable guidelines to avoid problems which arise in non-simultaneous exchanges and make them defensible. These deal with security arrangements for the taxpayer's benefit. When acting under Safe Harbor No. 3 of the Regulations, the party facilitating the exchange is called "the qualified intermediary". Safe Harbor No.4 of the Regulations deals with the interest on the money held in trust.

Exchanges under IRC 1031 are sometimes referred to as tax-free, tax-deferred, like-kind, starker, or nontaxable exchanges. The realized gain is deferred until the property acquired in the exchange is disposed of in a subsequent taxable transaction.

Today, a sale and a reinvestment in a replacement property are converted into an exchange by means of an exchange agreement and the services of a qualified intermediary- a third party who helps to ensure that the exchange is structured properly.

USING REAL ESTATE PROFESSIONALS AND COMMON MISUNDERSTANDINGS

The benefits of a 1031 Exchange to real estate agents are many. The first of which is an opportunity for agents to increase their income. Many real estate transactions take the form of a buyer or seller looking for investment opportunities. By identifying the needs of the client and matching with opportunities for an exchange, the real estate professional can effectively increase the number of "closings" and serve the best interest of their clients.

It is important to dispel some misunderstandings that exist regarding the 1031 Exchange process.

"1031 Exchanges take money out of the agent's pocket."

FACT: The more the real estate professional knows about 1031 Exchanges, the greater his or her earning power. An exchange involves the exchange of one property (which is sold to someone else) for another or many more properties. By understanding the exchange process, the real estate professional will potentially increase his/her individual earnings.

"1031 Exchanges are too complicated and require extra work of the real estate professional."

FACT: 1031 Exchanges do not involve additional work by the agent. The qualified intermediary will work with you, the seller, the Title Company, and attorneys to facilitate the transaction. The agent should be knowledgeable about the process, however involvement is limited. The qualified intermediary does the work expeditiously and with precision to insure a smooth transaction.

Responsibilities of the agent or broker:

*Place simply worded exchange language into the purchase agreement.
*Send purchase agreement to the qualified intermediary.
*Advise client of any earnest money required for the replacement property.

It is also important to note that, where a Real Estate Professional may have used an escrow company to hold proceeds and an attorney to "draw up" the documents, the qualified intermediary will do that and more, for (usually) less – saving their client money.

"Exchanges can only be of land for land, rental for rental, etc."

FACT: Any given exchange must only be of "like-kind" property for "like-kind" property. 1031 defines "like-kind", as it relates to real property, as "property held for investment or productive use". This includes vacant land, residential rental property, commercial property, condominiums, apartment buildings, or any real property that is not the exchanger's primary residence. When an exchange takes place, any mixture of these types of properties is allowed. For example, a rental home may be exchanged for vacant land or a commercial property may be exchanged for residential rental property.

"The closing is tomorrow. It's too late to do an exchange."

FACT: Until title has passed to the buyer and money is received, it is not too late to set up an exchange. The qualified intermediary has shown its adaptability and responsiveness on many occasions by setting up the exchange as parties sit at the closing table. Although more lead-time is desired, do not abandon the possibility because of the last minute decision.

"The seller (exchanger) doesn't know whether they want to do an exchange or not. It wouldn't be worth it to go to all the trouble of setting it up."

FACT: The qualified intermediary can set up documentation to give the seller the continued option of doing an exchange. If it is later decided that an exchange is not desired, a nominal "cancellation" fee will be charged and money will be refunded to the seller. If a significant tax burden looms, this option should be well worth the cost.

"The seller is selling (to one party) and buying (from another party) all on the same day. They don't need the qualified intermediary for this 'simultaneous' exchange."

Fact: Unless the taxpayer is selling to and buying from the same party, without an intermediary, there is no exchange. It is simply a sale and a purchase. The transaction becomes an exchange when the intermediary “sells” one property and “ buys” the other, making this an “exchange” between the taxpayer and the intermediary. Anything other than this, even though all may take place on the same day, is not an exchange.

“We will just have the title or escrow company hold the money from the sale and they will be the intermediary.”

FACT: A title or escrow company can hold the funds, but that, in itself, does not make them an intermediary. An exchange agreement must be in place between the taxpayer and the intermediary; and the intermediary must be a disinterested third party. There is debate on whether or not the title company that closes the transaction would be considered “disinterested”. An agent to the taxpayer cannot act as intermediary. This includes the taxpayer’s attorney, accountant, real estate professional, or anyone else that has been involved in an agency relationship with the taxpayer two years prior to the exchange or that may act as agent within two years after the exchange.

“Doing an exchange costs too much. I’d be better off just paying the taxes”

Fact: The cost of doing a tax-deferred exchange is fixed. It should be very clear whether this would be worth it or not.

“I’m looking to sell my residential rental property because I’m tired of dealing with tenants, so I don’t want to get into another rental situation.”

FACT: There is the option of purchasing property other than the type that will require you to engage in property management. Many opportunities exist for passive real estate investments with little or no management responsibility.

“I own property with my brother-in-law and he doesn’t want to exchange, so I guess we’ll just have to sell and pay the taxes.”

FACT: As separate owners of undivided interest, it is not necessary that both parties take the same action. One may exchange and one may sell outright, both completely independent of the other’s decision. (Some complications exist if a partnership or corporation owns the property.)

“I would like to trade into a less expensive property and take out some cash from my sale to pay some bills, but I’ve heard that you must trade up in an exchange.”

Fact: In order to defer all capital gains taxes, it is true that you must trade across or up, but this is not a requirement to so an exchange. You can trade down, pay some taxes, and defer a good portion of your gain. There are also some financing possibilities involving the addition of debt to a property where some cash may be pulled out on a tax free basis. It is really up to you how far you would like to go.

BENEFITS TO THE EXCHANGER

Exchanges are important to the taxpayer who wants maximum investment or business performance. By taking advantage of a 1031 exchange, you can:

- Conserve equity by deferring tax on realized gain;
- Increase depreciable basis by acquiring property encumbered with a larger debt;
- Acquire sheltered income by exchanging unimproved land for improved rental property;

- Reallocate basis by acquiring property with a higher building-to-land ratio;
- Acquire property without cash;
- Receive nontaxable cash by exchanging for property which is refinanced after, and independent of, the exchange;
- Acquire property that is appreciating faster than the property transferred;
- Increase net cash flow and equity build-up by acquiring property with a lower debt service payment and interest rate;
- Consolidate assets by exchanging many properties for one equal to their combined values;
- Pyramid holdings by exchanging up, acquiring properties with larger total value by using the profit realizing through appreciation and loan amortization as nontaxable acquisition power;
- Relocate or expand business facilities or investment holdings to a different geographic area without depleting equity by paying tax;
- Conserve an individual's estate by exchanging throughout life without loss of appreciated value to tax;
- Complete a transaction not otherwise possible due to the tax consequences;
- Automatically solve the problem of where to invest profit by arranging an acquisition by exchange, rather than a one-sided sale;
- Diversify holdings and spread of investment risk among several smaller properties;
- Create a multiparty exchange by arranging a sale concurrently with the exchange to meet the objective of an owner desiring cash;
- Reduce property management problems by exchanging for property that is management-free or capable of supporting professional management.

COMMON 1031 EXCHANGE QUESTIONS AND ANSWERS

"Why would a taxpayer want to do a 1031 Exchange?"

If the taxpayer is selling an investment property that will result in a capital gain and they intend to reinvest the proceeds in another investment property, a 1031 Exchange is the only logical choice. By exchanging, they can reinvest everything from their sale into the replacement property instead of paying the capital gains tax.

"Who can do a 1031 Exchange?"

Any entity that owns interest in investment property can do a 1031 tax-deferred exchange, including (but not necessarily limited to) all of the following:

- Individuals
- Corporations
- Partnerships
- Limited Liability Companies
- Trusts

"Can the properties be located anywhere in the country?"

All property involved in an exchange must be located within the United States. The properties need not be located in the same state.

"What kinds of time limitations are there in a 1031 Exchange?"

From the date the relinquished property is transferred to the buyer, the taxpayer has:

- 45 days to identify replacement property followed by
- 135 days to acquire replacement property
- A total of 180 calendar days.

“At what point does the taxpayer need to decide if they want to “exchange” their property?”

The paper trail is the key to a successful exchange. Therefore, certain key elements should be considered. At some point before the first transfer of property, the taxpayer MUST have an exchange agreement in place with a qualified intermediary. This exchange agreement will clarify intention and serve as the main underlying document in the event of an audit.

“What must be done in order to defer ALL capital gains taxes?”

The value of and equity invested in the property (or properties) acquired must equal or exceed that of the property relinquished. In other words, a debt must be replaced and all equity (cash) must be reinvested in the replacement property.

“How do I calculate my gain?”

Start with the price you paid for your property, subtract any depreciation and add any capital improvements. This figure is your adjusted basis. Subtract the adjusted basis and the new costs of sale from the new sales price and the remaining figure is your gain. Expect to pay 20% of that to the Federal Government, plus applicable state taxes, if you do not exchange!

“What if I live in part of the property?”

You can exchange a portion of your property if it has been held for investment purposes. Frequently, a farm or ranch falls into this category. A multi-family property might also be part residential and part investment property.

“What happens if I buy down in value?”

If you go down in value, you can still do an exchange to defer a portion of your transaction; however, you will pay taxes on any funds you receive upon completion of the exchange. Closing costs may also offset the price differential. You also may wish to acquire more than one property!

“Can I exchange my vacation home?”

Vacation homes fall under very strict guidelines to determine if they are actually investment property. If you have rented out the property while you owned it, it may qualify for tax deferral. In addition, if you have not used the property as your primary residence, you might be able to convince the IRS it was held for investment.

“I’m dissolving a partnership, how does that affect exchange?”

The same entity that relinquishes property must acquire property to qualify for an exchange. If some of the partners simply want cash and so not intends to exchange, they can be cashed out when the sale closes and the partnership can remain intact and acquire property. However, if various partners want to go their separate ways but still want to exchange, then the only real option is for the partnership to deed the appropriate percentages to the various partners before the sale closes. There is risk in this, however, in that 1031 is for property HELD for productive use in business, trade or for investment purposes. If the partnership deeds to the individual partners, has the property then been "held" by the individuals? The IRS has not defined what constitutes "held"!

"Why does it matter that I've married since I bought the property I'm selling?"

If you sell a property that you own solely, and your spouse does not have an interest in the old property but does acquire new property with you, the IRS could give you credit for only one-half of the purchase! Depending on the values of the properties involved and whether or not you live in a community property state, this could result in a significant tax bill.

"What is 'like-kind'?"

On real property, "like-kind" can be any property held for business, trade, or investment purposes! This would exclude only your principal residence for real property exchanges. Like-kind personal property is much more specific in that a cow can be exchanged for a cow (not a bull), an airplane for an airplane, etc.

"Can I exchange timber or water rights?"

If timber rights have been held for a year or more, they can be exchanged for other timber rights. If the trees have not been removed from the property, they may be considered real property and exchangeable for other investment property. Each state handles timber rights differently. However, as a general guideline, if you acquired the timber rights via a deed as opposed to an assignment or bill of sale, they are probably considered real property. Similarly, state law determines whether or not water rights are real property. If the property was also used for investment purposes, the water rights could be exchangeable. Be sure to consult an attorney who specializes in timber or water rights, in your state, before entering into an exchange of this kind.

"What are the time periods for the exchange?"

All time periods begin upon the closing of the sale of the relinquished property. The exchanger must identify the property to be acquired no later than midnight of the 45^{th} calendar day after the close date. The exchanger must then acquire one of the properties identified no later than midnight on the 180^{th} calendar day following the sale, or the tax filing deadline (including extensions) for the year in which the relinquished property closed, whichever is sooner. In no event can these deadlines be extended.

"What are the rules of identifications?"

The IRS allows three variations to use when identifying property the exchanger intends to acquire:

- Three property rule: Any three properties can be identified (complete address or legal description) and any one or more of these then needs to be acquired.
- The 200% rule: The exchanger may identify as many properties as he desires as long as the total market value of the properties does not exceed 200% of the value of the relinquished property.
- The 95% exception: Automatically used if neither of the above rules apply. Simply stated, the exchanger must acquire 95% of what was identified! This certainly keeps people from identifying entire blocks of potential properties!

"Is a qualified intermediary needed if all properties are closing concurrently?"

Yes, if there are more than two properties involved. If two exchangers want each other's properties, a qualified intermediary is not required. If three or more properties are involved, someone has to either go through the chain of title to make the exchange work or utilize a qualified intermediary to prepare the documents required by the IRS to show the trade.

"When can I obtain my money if I choose not to exchange?"

In order to qualify for an exchange, the qualified intermediary MUST restrict the exchanger's access to the funds. IRS Code 1031 clearly states the exchanger may receive the exchange funds:

- he fails to identify within the 45 days he may receive the funds on the 46th day, or
- he fails to acquire property, he may receive his funds on the 181st day.

There may be some leeway if the exchanger is unable to acquire property identified due to a material fact beyond the exchanger's control. However, this would need to be determined on a case-by-case basis. Of course, if the exchanger acquires one property and has money remaining, those funds will be returned after notification to the qualified intermediary that there are no other properties to be acquired and the identification period (45 days) has been exceeded. The exchange is completed.

"What happens if I forgot to put a cooperation clause into my sales contract?"

The cooperation clause is designed to clearly show the exchanger's intent to exchange. It is possible to accomplish an exchange by adding this statement after the initial acceptance of the offer and before the sale closes. Another way to accomplish this is to simply have the buyer sign the Assignment of the Purchase Contract prepared by the qualified intermediary (which is the extent of cooperation required). Certainly for negotiation purposes, it is best to get an agreement to cooperate early in the transaction.

"Why can't my real estate agent act as a qualified intermediary?"

The IRS disqualifies any agent or related party of the exchanger to act as a qualified intermediary. If in doubt about whether or not someone is an agent or related party, if there is a relationship by contract or blood, there is probably a relationship that could disqualify the exchange. With intermediary fees so reasonable, there is no need to risk the possible tax consequences.

"Can I borrow against the funds held by the qualified intermediary?"

Borrowing or pledging the funds would represent the exchanger's control of the money, which would make it taxable and would disqualify the exchange.

"Can I take money out of the exchange?"

The exchanger may receive funds at the close of the sale escrow (prior to the funds going to the qualified intermediary) by instructing escrow accordingly. No funds can be disbursed to the exchanger while held by qualified intermediary.

"Can I receive the interest on the funds while held?"

Any interest earned by the exchanger can only be disbursed upon completion of the exchange. Otherwise, the exchanger would be benefiting from the funds, which would constitute "constructive receipt" of the funds and be taxable. The qualified intermediary will issue a 1099 statement for the tax year during which the interest was actually paid to the exchanger.

“Can the qualified intermediary advance funds from the exchange for fees and costs needed to acquire the replacement property?”

Funds can be disbursed to escrow for earnest money or common expenses such as appraisals and credit reports when the qualified intermediary has been assigned into the transaction in place of the exchanger. Funds must be requested by escrow (not the exchanger) to avoid the issue of the exchanger’s control of the funds. If the exchanger advances any of these funds, they can be reimbursed at the close of the escrow without triggering any taxes.

“I’ve been asked to carry a loan for my buyer, how does that affect the Exchange?”

A seller carry-back can be treated as an installment sale or may be deferrable upon certain conditions (call for an in-depth review). The important thing to remember is that the method of handling a carry-back will have important tax ramifications to the exchanger. The options must be discussed and an action determined **BEFORE THE SALE CLOSES.**

“What is a “reverse” exchange?”

Simply stated, a reverse exchange is the exchange acquiring the property he wants before he has sold the property he intends to sell. Call for detailed flowcharts of the various methods of structuring a “reverse” exchange.

“Can I improve property I already own?”

You cannot trade real property for improvements, as they are not like kind. In addition, if you own both properties at the same time, there can be no trade. Though there have been some recent encouraging court cases, if at all possible, do not acquire the replacement property until the improvements have been made. There are ways to make the improvements tax deductible via a “build-to-suit” or “workout” exchange-call for details.

“How many properties can I buy or sell in one exchange?”

Buy as many as you can afford and can close within the time period. Sell as many as you can, provided they could all close within the **TIME PERIOD SET BY THE CLOSING OF THE FIRST SALE.**

Please note: Many of the situations mentioned above are subject to varied interpretation and/or require more detailed information than space allows. Please call for details and check with your CPA or tax attorney before proceeding with your exchange.

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