1031

Exchange

1031 Tax-Deferred Exchange

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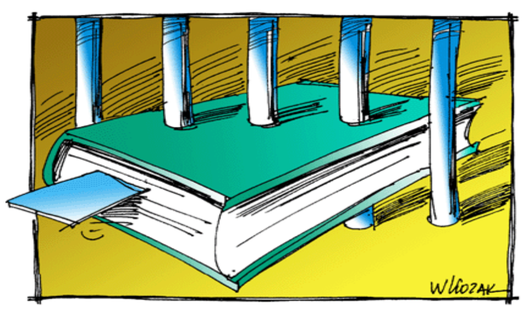
COURSE OUTLINE

1031 Exchange Concepts

Completing a Tax Exchange requires an in-depth understanding of taxation, the exchange process, and most importantly an ability to quickly identify replacement investments. In short, it requires unique investment knowledge, tax expertise, transactional experience, and professional service skills.

1031 Exchange services are available to assist Exchangers and their advisors with their exchange strategies. The Exchange is always advised to discuss the intended exchange with their tax advisor or CPA.

A 1031 Exchange (Tax-Deferred Exchange) is one of the most powerful tax-deferred strategies remaining available for taxpayers. Anyone involved with advising or counseling real estate investors should know about tax-deferred exchanges, including realtors, lawyers, accountants, financial planners, tax advisors, escrow and closing agents, and lenders. Taxpayers should never have to pay income taxes on the sale of property if they intend to reinvest the proceeds in similar or like-kind property.



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This course will outline the basic steps you need to take in order to qualify for 1031 Exchange.

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What is the role of a Qualified Intermediary?

The role of the Qualified Intermediary is essential to completing a successful and valid exchange. The IRS says if you have the position of the money, you pay tax. However, If you use a qualified intermediary to transfer the money from the property that you sold into purchased property, you qualify for a tax-free exchange.

A qualified intermediary will consult, structure, guide, and document the 1031 exchange transaction from beginning to end. In order to take advantage of the qualified intermediary there must be a written agreement between the taxpayer and intermediary expressly limiting the taxpayer’s right to receive, pledge, borrow, or otherwise obtain the benefits of the money or property held by the intermediary. The intermediary can act with respect to the property as the agent of any party to the transaction.

What the qualified intermediary does:

Prepare the documentation for the Relinquished Property and the Replacement property.

Furnish escrow with instructions and documents to effect the exchange.

Secure the funds in an insured special bank account until the exchange is completed.

Coordinate with the exchange and their advisors, to structure exchange.

Exchange Definitions

No gain or loss shall be recognized on the exchange of the 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.

A tax-deferred exchange is a method by which a qualified property can be sold and another property acquired without having to pay any tax.

Section 1031 of the Internal Revenue Code establishes the rules for an investor to defer the payment of capital gains taxes on the sale of an investment property.

The intention of the investors to defer 100% of their capital gains taxes, the investor Simply needs to reinvest all the cash that was generated from the sale of the old property and purchase property equal or greater in value to the property sold.

The primary motivating factor for any 1031 Exchange is a deferral of the capital gains taxes. An investor doing a 1031 Exchange can deferral payment of the following taxes: 15% Federal Capital Tax Rate, 25% Federal rate for the recapture of depreciation.

A growing number of investors are structuring their real estate transactions and qualifying them as tax-deferred exchanges with the future capital gain rates swinging in the balance.

The Concept of "Like-kind"

Any type of property (real or personal) can be exchanged, provided it's held "for productive use in a trade or business" or "for investment," and is exchanged for property of like- kind that will also be held "for productive use in a trade or business," or "for investment."

"Like-kind" doesn't mean "exactly the same," especially in an exchange of real properties. A single-family rental unit, for example, may be used to acquire another like it or to purchase a warehouse, retail center, office building, industrial, land, apartment, medical, duplex, or single-family rental.

Substantially any real property is considered "like-kind" to other real property. The like-kind limitations applied to personal property are much more restrictive. Essentially, items of personal property must be classified similarly under certain government accounting classifications.

What is considered "Like-kind" Property?

QUALIFYING REAL PROPERTY

Real Property must be exchanged for like-kind real property. Any real estate held for productive use in a trade or business or for investment – whether improved or unimproved – is considered "like-kind." Like-kind examples:

1.) Single-family Rental

2.) Office Building

3.) Medical Building

4.) Shopping Center

5.) Retail Store

6.) Industrial Property

7.) Raw land

8.) Apartment

9.) Duplex

Examples of Qualifying Exchange Properties include:

- **Unimproved for improved property**
- **Commercial building for vacant land**
- **Duplex for commercial property**
- **Single family rental for an apartment**
- **Industrial property for rental resort property**
- **Apartment for retail center**

Like-kind personal property includes:

Restaurant equipment for restaurant equipment
Buses for buses
Automobiles for automobiles
Doctor practice for doctor practice
Manufacturing equipment for manufacturing equipment
Beauty salon for beauty salon
Yachts for yachts

Exchange Requirements for Non-recognition of Gain

There are three conditions that must be met to accomplish non-recognition of gain under Section 1031 Exchange:

1. The properties exchanged must qualify and be of "like-kind."
2. There must be an actual exchange, not a transfer of property for money only.
3. The time requirements must be strictly followed.

Excluded Property

The following types of property do not qualify for Section 1031 Like-kind Exchange Treatment:

- Inventory
- Partnership Interests
- Securities (e.g. stocks and bonds)
- Goodwill or going concern value of a business; can never be a like-kind
- Entire businesses – The exchange of one business for another does not meet the requirement of Section 1031.

Qualified Properties

To meet the requirement of 1031 both **Relinquished** Property and **Replacement** Property must qualify. In other words, both properties must be like kind, if not, your exchange will fail and be classified as a sale. To qualify as a like-kind exchange, the properties must be 1-Qualifying property; and 2-Like-kind property.

For income tax purposes, real estate is divided into four classifications:

1. **Held for business use**
2. **Land held for investment**
3. **Held for personal use**
4. **Held primarily for sale (dealer property)**

Listing Agreement

Exchange Verbiage

The owner named herein has elected to effectuate a tax-deferred exchange under Internal Revenue Code Section 1031, and shall be exchanging the within-described property for property of a like kind.

Offer & Acceptance – Relinquished Property

Buyer(s) agrees to cooperate with Seller(s) to assist Seller(s) in effect a tax-deferred exchange of the within a property for like property pursuant to Section 1031 of the Internal Revenue Code. Seller(s) reserves the right to substitute ownership in escrow and assign Seller's position in this transaction to affect the contemplated exchange. The exchange shall be entered into sufficient time to close all transactions pursuant to the terms and conditions set forth in this escrow. Seller(s) shall pay any and all additional costs and expenses that may be incurred to affect Seller's exchange through escrow.

Seller is aware that Buyer is to perform a 1031 tax-deferred exchange. Buyer requests Seller's cooperation in such an exchange and agree to hold Seller harmless from any and all claims, liabilities, costs, or delays in time resulting from such an exchange.

The information described above is simply a brief overview of the new provisions and is not intended to provide a complete or comprehensive coverage of the revenue procedures. All taxpayers should consult with their tax and legal advisors regarding their particular circumstances.

Related Party Transactions

The two-year holding period requirement

There is a special rule for exchanges between related parties which requires related taxpayers exchanging property with each other to hold the exchanged property for at least two years after the exchange to qualify. If either party disposes of the property received in the exchange before the running of the two-year period, any gain or loss that would have been recognized on the original exchange must be taken into account on the date that disqualifying disposition occurs.

Related-party transactions need to be approached with a great deal of caution. The related party should be made to understand the tax consequences to an Exchanger if the related party sells within two years.

The statute provides an exception to the two year period if

A. The subsequent disposition is caused by the death of taxpayers or related party;
B. Compulsory or involuntary conversion which was threatened or imminent at the time of the exchange party; or
C. The taxpayer can establish that neither the exchange nor the disposition was principally designed to avoid income tax.

Related parties under the rules are the following

Family- An Exchange and a member of the Exchanger's family.
Exchanges between the Exchanger and the following relatives are affected:

Brothers and sisters	Children	Grandchildren	Great Grandchildren
Spouse	Parents	Great Grandparents	Great Grandparents

A corporation and a partnership, if Taxpayers own, directly or indirectly, more than 50% of each;
An individual and corporation, if an individual owns, directly or indirectly, more than 50%
of the corporation;
An individual and a partnership, if the individual owns directly or indirectly, more than 50% of the capital interest;
A grantor and fiduciary, and the fiduciary and beneficiary, of any trust;
A grantor and a fiduciary of the same trust;
Two sub S corporations that are controlled by one person, directly or indirectly;
A fiduciary and beneficiary of the same trust;

Determining the Proper Vesting

The following are some examples of the real estate exchange operation in general:

1. Husband relinquishes, then the husband must acquire.
   David Lee Partnership relinquishes, then David Lee Partnership must acquire.
   Jackson LLC relinquishes, then Jackson LLC must acquire.
   ABC Corporation relinquishes, and then ABC Corporation must acquire.

If you sell as an individual, you must acquire as that same individual.
If you sell as an equity partnership, you must acquire as that same equity partnership.
If you sell as a corporation, you must acquire as that same corporation.

The following scenarios are disallowed:

2. Husband relinquishes and husband and wife acquire property of equal value.
   Capital Corporation relinquishes, and Express Corporation acquires.
   City Partnership relinquishes, and partners acquire as individuals.
   David Kim Partnership relinquishes, and XYZ Partnership acquires.

The following are examples of some of the exceptions that apply:

3. Husband and wife as trustees of a revocable living trust, which is a true pass-through trust, relinquish and acquire as individuals.
   Single-member LLC relinquishes, and the sole member acquires as an individual.
   Individual relinquishes and Individual's estate is acquired due to the death of the individual.
   Trustee of a revocable living trust, which is a true pass-through trust relinquishes, and the Trustee acquires as an individual.

Single Member Limited Liability Company

A single member can elect to have the limited liability company taxed as a sole proprietorship.

A single Exchanger can sell the relinquished property as an individual and acquire the replacement property as a limited liability company.

A husband and wife who own the membership interest as community property may be treated as a single member.

Corporations
Corporation that owns relinquished property must acquire replacement property.
Changes in stock ownership do not affect exchange.

1031 Exchange into rental property first;
held as a rental property;
Primary residence at date of sale

A taxpayer can dispose of rental or investment property as part of a 1031 exchange and acquire like-kind replacement property. The taxpayer would then rent out the property for a period of 12 to 16 months in order to qualify for 1031 exchange treatment. Subsequent to the rental period the taxpayer would move into the property convert it to his primary residence and live in the property for at least 24 months in order to qualify for a 121 exclusion. Once a taxpayer has owned the property for at least five years, then he could sell the property and take advantage of the 121 exclusion.
Make sure you follow the below guidelines.

1- Rent the newly acquired replacement property for at least 12 to 16 months in order to Qualify for 1031 exchange treatment.

2- Live in the property for at least two years after it has been converted into a primary residence in order to qualify for the 121 exclusion.

3- Own the property for at least five years. This is the only new requirement effective October 22, 2004.

Primary residence first:
Rental property at date of sale

Property that was originally held and used as the taxpayer's primary residence in the past, but subsequently converted to and held as investment property up to the date of sale, can now be sold and the taxpayer can apply the 121 Exclusion first up to the permitted limits as previously explained and then defer any remaining capital gain or depreciation recapture with a 1031 exchange. Section 121 is applied to gain realized by the taxpayer first before section 1031 is applied to any portion of the sale, or exchange of the property.

Rental property first;
Residence at date of sale;
no 1031 exchange involved;

Property acquired by a taxpayer as rental investment or business use property could later be converted by the taxpayer into his primary residence. Once a taxpayer has lived in the property for at least 24 months out of the last 60 months the taxpayer could sell the property and exclude from taxable income up to $250,000 or $500,000 in capital gain taxes as 121 Exclusion.

Real Estate Exchanges

Some important rules:

1. You must notify the buyer of your original property that you are performing a Section 1031 Exchange.
2. The exchanger must use a qualified intermediary.
3. The exchange must identify their replacement property within 45 days of the sale of the original property.
4. The exchanger must purchase their replacement property within **180** days of selling the original property.
5. The names on the title of the old property must be identical to the names of the title of the new property.

You may identify more than one property as Replacement Property subject to three rules:

1. The Three Property Rule

The maximum number of replacement properties you may identify is **three** properties without regard to fair market values of the properties.

2. The 200 Percent Rule

You may identify any number of properties as long as their total fair market value does not exceed **200 percent** of the total fair market value of all relinquished properties.

3. The 95 Percent Rule

You may identify any number of replacement properties if during the exchange period you actually received replacement properties having a fair market value equal to or more than **95** percent of the total fair market value of all identified replacement properties.

Five Ways to Exchange

Delayed Exchange

The delayed exchange is the most common type of exchange. In a delayed exchange, the relinquished property is transferred first, and then the replacement property second.

Simultaneous Exchange

A simultaneous exchange occurs when ownership of both the relinquished property and the replacement property transfers at the same time on the same day at the same title company.

Personal Property Exchange

Similar to real property, personal property held for investment or productive use in a trade or business may be exchanged for like-kind personal property under section 103 of the Internal Revenue Code. Thirteen general classes provide the definition for like-kind tangible personal property exchanges. Investors may exchange business asset, airplanes, helicopters, automobiles, buses, tractors, valuable paintings, equipment or other personal property. Although business or personal property exchanges are common, sometime they can very difficult because they require very specific asset allocations.

Improvement Exchange

A build to suit Exchange is when the Exchanger wishes to improve replacement property. New construction or improvements can be added as part of the exchange with title passing to the intermediary who in turn makes payments to contractors and out of exchange funds. Improvement can be to raw land or to existing property.

Reverse Exchange

The reverse exchange is used when an investor wishes to acquire title to the replacement property before the relinquished property is sold. You list the property for sale but before you find a buyer, you discover the Replacement Property you want to acquire. But to get the deal you want, you must move fast. You decide to enter into a reverse exchange arrangement. A reverse exchange requires an independent third party (Exchange Accommodation Titleholder) to acquire and hold Replacement Property/Relinquished Property to allow the disposition/acquisition of the properties to be accomplished in the proper order.

New Construction Replacement Property

One of the more interesting stipulations is the regulation that permits you to exchange for real property that has not yet been built. A transfer will still qualify for **1031** treatment if the new construction is identified within the **45**-day period and received within the **180**-day exchange period. This property must be carefully identified. This identification should include the legal description of the underlying ground and as many other descriptions as possible for the property to be constructed. Also, the new construction must be completed and received in substantially the same form as described in the identification documents.

You cannot exchange for services. Partially completed real property can be received in a like-kind exchange if properly identified.

There are two ways that new construction is handled in an exchange:

You can contract with a builder to purchase a property, which will be completed, and ready to close prior to the end of the **180**-day exchange period, or you can purchase the land prior to construction as one of your replacement properties, or you can purchase the land and building from the builder at the time of closing. This is the least expensive and easiest method for the exchanger.

How to build a Replacement Property and perform a 1031 Exchange?

Yes, building a replacement property can be easy. The easiest way to perform this **1031 exchange** is to have your construction plans, permits, and contractor in place when you sell your original piece of property. If these steps are in place and your construction will be complete within six months of the original sale, then your exchange can be performed without a hitch. If you cannot have your construction completed within six months, then your gain will be calculated based on a percentage of completion.

What is a Reverse 1031 Exchange?

1031 Exchanges are specifically structured transactions that join together the sale of an old property and the subsequent purchase of a new property for the purpose of deferring taxes. As part of the IRS **1031** regulations, you are required to utilize a qualified intermediary (QI) to facilitate the exchange.

Unlike a typical **1031 Exchange**, you may need to buy your new property <u>before</u> you have sold the old one. Unfortunately, IRS regulations don't allow you to own **title** to the **old** and **new** properties at the same time.

In a reverse exchange, your qualified intermediary must arrange to **buy** the new property for you and hold it for a period of time.

How can a Reverse 1031 Exchange help you?

There are several reasons you may want to buy a new property before you have sold your old property.

How does the IRS treat Reverse 1031 Exchanges?

In the year 2000, the IRS issued Revenue Procedure 2000-37, a ruling that clarified the IRS' position regarding reverse exchanges. As a result, there are now **two types of reverse exchanges:**

1. "Safe Harbor" Reverse Exchange

Revenue Procedure 2000-37 established "safe harbor" procedures – IRS-approved guidelines for structuring a **reverse exchange**. Although these procedures are somewhat restrictive, meeting them ensures that the IRS will not disallow the exchange.
Safe harbor exchanges require specified documentation and must be completed within **180** days.

2. Traditional Reverse Exchange

Despite the issuance of the Revenue Procedure, the IRS has recognized that some valid reverse exchanges cannot be completed within the Safe Harbor structure and its 180-day deadline. For example, if your new property includes a construction project, it is often difficult to complete it within 180 days. These Traditional (non-Safe Harbor) exchanges have helped clients with specialized needs for many years.

While Traditional and Safe Harbor exchanges are similar, there are unique considerations and procedures for each.

How does a Reverse 1031 Exchange work?

In a reverse exchange, your qualified intermediary must arrange to buy and hold your new property until your exchange can be completed. This is done with an entity (usually a limited liability company) that the IRS calls an Exchange Accommodation Titleholder or "EAT."

A primary concern for any reverse exchange is financing. As the purchaser, the EAT must have the funds needed to purchase the new property. As the ultimate buyer, it is up to you to provide these funds. The expert can help you with this process. They have contacts with lenders who work with exchange clients, and lenders who are familiar, knowledgeable, and comfortable with the reverse exchange procedure.

Reduced Maximum Exclusion

You can claim exclusion, but the maximum amount of gain you can exclude will be reduced if either of the following is true.

1. You did not meet the ownership and use tests, but the reason you sold the home was:
    a. A change in place of employment,
    b. Health, or
    c. Unforeseen circumstances.

Change in place of employment

The sale of your main home is because of a change in place of employment if your reason for the sale is a change in the location of employment of a qualified individual. The new place of employment is at least 50 miles farther from your home than the former place of employment was.

Health

The sale of your main home is because of health if your primary reason for the sale is to obtain, or facilitate the diagnosis, cure, mitigation, or treatment of disease, illness, or injury of a qualified individual.

Unforeseen Circumstance

The sale of your main home is because of an unforeseen circumstance if your primary reason for the sale is the occurrence of an event that you could not reasonably have anticipated buying and occupying your main home.

1. An involuntary conversion of your home
2. Natural or man-made disasters or acts of war or terrorism resulting in a casualty to your home.
3. Change in place of employment
    a. Death,
    b. Unemployment
    c. Divorce or legal separation
    d. Multiple births resulting from the same pregnancy, or
    e. A change in employment that results in your inability to pay reasonable basic living expenses.

Exchangers should carefully consider the following issue to avoid the pitfalls of the "step transaction doctrine."

- The refinance loan should not appear to be solely for the purpose of "pulling out equity" thereby avoiding the capital gain tax that is otherwise attributable to non-exchange transactions.

- As a rule of thumb, the refinance transaction should be separated from the exchange sale or purchase transaction to help separate the exchange from the refinance.

- At a minimum, the exchanger should attempt to complete the refinancing transaction prior to listing the relinquished property for sale.

- The refinance loan and the sale or purchase in the exchange should be documented as separate transactions to avoid any "interdependence" of the transactions.

Owner carries financing in 1031 Exchange

If you carry back a note on your sale property, the IRS will treat this note as taxable. As the payments on the note come to you, the principal portion of the payment is subject to capital gains tax, and the interest portion is subject to ordinary income tax. How can you prevent this note from being taxable? First, the note should be payable to the QI, which puts the note into the exchange. The note must then be converted to cash before you can buy your new property. How do you turn the note into cash? **There are three ways:**

Number one is to get the seller of the new property to agree to take the note as part of the purchase of the new property. As a practical matter, you almost never see this.

Number two is to find someone to buy the note. Unfortunately, because the note is unseasoned, (i.e., it's a brand-new note) any buyer of that note will demand a large discount.

Number three is that you, as the property seller, buy the note from the QI for face value, and the QI assigns the note back to you. Because you bought the note from the QI at face value, as you receive the principal payments, they're tax-free returns of basis to you. You will pay income tax on the interest on the note as you receive it, but the principal payments are tax-free. Meanwhile, in your exchange account, the QI is holding cash that can now be used to purchase the new property.

Partnership Interests

Your interest in a partnership doesn't qualify under 1031 if traded for an interest in another partnership. However, a partnership as an entity can exchange real estate it owns for other like-kind real estate.

Transfers between Spouses

There are no income tax consequences in entering into financial transactions between spouses. In addition, most transfers incident to a divorce are tax-free.

Trade Even or Up In Value

The replacement property you wish to acquire needs to have a value equal to, or greater than, the adjusted sales price of the relinquished property. All proceeds from the Relinquished Property sale need to be invested in the Replacement Property.

New Tax Terms

A deferred exchange is an exchange in which you transfer qualified property called the **"relinquished property"** and subsequently receive qualified property as consideration. The property received is called **"replacement property."**

Sale of a Relinquished Property to a Related Party

A related party can buy relinquished property from the taxpayer. If they do so, there is a **two-year** minimum holding period during which the related party cannot sell the property they have acquired. There are exceptions such as death, involuntary conversion, the forcible taking by eminent domain. If the property is sold during this period, it will roll back and trigger the tax on the exchange.

IRS Clarifies Status of Tenancy in Common & 1031 Exchange Investments

Some investors engaged in **1031 tax deferred exchanges** looking for suitable replacement property have been reluctant to invest their **1031 Exchange** proceeds in Tenancy in Common (TIC) properties – where the investor becomes a tenant in common owner in a commercial property. It was unclear if the IRS viewed the TIC arrangement as an investment in real estate (as required by **Section 1031**) or as an investment in a security or partnership.

Rev. Proc. 2002-22, issued on March 19, 2002, specifies when the IRS considers the purchase of a TIC interest investment in real estate: "The central characteristic of a tenancy in common…is that each owner is deemed to own individually a physically undivided part of the entire parcel of property. Each tenant in common is entitled to share with the other tenants…the associated rights to a proportionate share of rents or profits from the property, to transfer the interest, and to demand a partition of the property."

Rev. Proc 2002-22 establishes requirements that qualify an arrangement as a TIC:

1. Each co-owner must hold title to the property as a tenant in common under local law.

2. The number of co-owners must be limited to 35 persons; a husband and wife are counted as one.

3. The co-ownership may not act as a business entity.

4. Co-owners must retain the right to approve the hiring of managers, sale of the property, or leases on the property.

5. Each co-owner must have the rights to transfer, partition, and encumber the co-owner's undivided interest in their property without the approval of any other person.

6. All revenues and costs must be shared in proportion to each co-owner's undivided interest in the property.

1031 Tax-Deferred Exchanges

Acceptable and Non-Acceptable Expenses for Exchange

Acceptable Expenses	Non-Acceptable Expenses
• Commissions and/or Finder's Fee(s)	• Loan Fee(s) and/or related Loan Charges (i.e. Loan Points, Application Fee, Mortgage Insurance Premiums and Lender's Assumption Fee)
• Exchange/Qualified Intermediary Fee(s)	• Rent Perorations
• Escrow Fee(s)	• Security Deposits
• Attorney/Legal Fee(s)	• Premiums for Property Insurance
• Premium for Owners Title Insurance	• Property Taxes
• Recording Fee(s)	• Premiums for Lender's Title Insurance
• Transfer Taxes	• Utilities
• Recording of Documents	
• Inspection and Testing Fee(s)	

***The information contained herein is presented for informational purposes only. For complete information on acceptable deductions please consult your tax advisor and /or attorney.**

Basis: "Basis" is the cost of the property.

Adjusted basis is calculated by adding improvements made to the original purchase price and then subtracting the depreciation taken. This adjusted basis is used to determine the capital gain in a particular transaction.

Example:	Original purchase price	$900,000
	Add (Capital improvement)	$150,000
	Less; Depreciation	- 450,000
	Equal: Net Adjusted Basis	$600,000

	Relinquished Property	Replacement Property
Value	$1,000,000	$1,200,000
Net Equity	$600,000	$600,000
Debt	$400,000	$600,000

The taxpayer is purchasing property of greater value, reinvesting the entire net equity and increasing the mortgage on the replacement (new property). There is no boot and no recognized gain.

	Relinquished Property	Replacement Property
Value	$1,000,000	$1,000,000
Net Equity	$600,000	$500,000
Debt	$400,000	$500,000

The taxpayer keeps $100,000 of the exchange proceeds and reinvests only $500,000 as a down payment on the replacement (new property). There is $100,000 of cash boot which results in recognizes taxable gain.

	Relinquished Property	Replacement Property
Value	$1,000,000	$900,000
Net Equity	$600,000	$600,000
Debt	$400,000	$300,000

The taxpayer is purchasing property of a lower value and reinvesting all equity in the replacement (new property) and acquires less debt in this process. The taxpayer has reduced the debt by $100,000 (mortgage boot) which results in a recognized taxable gain of $100,000.

1- Value 2-Net equity (after deducting costs of sale) 3- Debt

Don’t sell your investment property until you

Do the Math

Taxes are paid on capital gain. Capital gain is simply the difference between the sales price and the adjusted basis.

1- Calculation of Adjusted Basis: Example

Purchase Price	$1,000,000	----------------------
Plus improvements	$65,000	----------------------
Minus Depreciation	($440,000)	----------------------
Equals Adjusted Basis	<u>$625,000</u>	----------------------

2- Calculation of Capital Gain

Sales Price	$1,500,000	----------------------
Minus Exchange Expenses	($75,000)	----------------------
Minus Adjusted Basis	($625,000)	----------------------
Equals Capital Gain	<u>$800,000</u>	----------------------

3- Calculation of Capital Gain Tax

Gain attribute to depreciation ($440,000 x 25% =depreciation)	$110,000	----------------------
Plus Federal Capital Gain Tax ($800,000 – $440,000=$360,000 x%15)	$54000	----------------------
Plus State Capital Gain Tax ($800,000 x 10%= $80,000)	$80,000	----------------------
Combined Tax Due	<u>$244,000</u>	----------------------

This information is not intended to replace qualified legal and/or tax advisors.

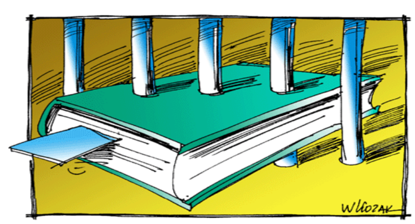
We do not provide tax or legal advice. Consult with your tax adviser to determine whether or not an exchange is appropriate for you.

100% Deferral

In order to fully defer state and federal capital gain taxes, the Exchanger must reinvest all exchange proceeds and acquire property with equal or greater debt or reinvest additional cash equal to the debt relief. The following example is useful to determine the amount of cash debt that should go into replacement property.

Relinquished Property	Example	Replacement Property	Example
Sale Price	$800,000	Purchase Price	$1,000,000
Minus Existing Loan	$300,000	Minus New Loan	$660,000
Minus Exchange Expenses	$60,000	---	
Equals Net Proceeds	$440,000	Equals Minimum Down	$440,000

Your minimum down payment for the replacement property should be equal to or greater than the net proceeds from the sale of your relinquished property. Otherwise, you may have booted in form of cash.



Answers to common questions

How do you determine who is considered a related party?

A related party is considered someone who is directly related by blood or, for tax purposes, has a relationship with the taxpayer as described in code sections 267(b). Obviously, someone directly related by blood would be your father, mother, sister, son, or daughter.

What is a Constructive Receipt?

Simply put, constructive receipt occurs when the taxpayer is deemed to have control of any funds derived from the disposition of the relinquished property. The taxpayer does not necessarily have to receive the money for him to have a constructive receipt. Control of the fund is the issue.

What is the best way to avoid Constructive Receipt?

The most widely accepted practice to avoid potential tax consequences of constructive receipt is the use of a Qualified Intermediary.

A qualified intermediary will help to facilitate your exchange and to avoid constructive receipt problems.

Asking the Key Questions

1-(Q) Do I need to do a 1031 Exchange for my personal residence?

(A) No, the home you reside in isn't considered property held "for productive use in a trade or business" or "for investment" and therefore, doesn't meet the requirements of Section 1031. However, Internal Revenue Code Section 121 allows an individual to exclude from taxation up to $250,000 of the capital gain realized on the sale of the individual's principal residence. A married couple filing jointly can exclude up to $500,000. Section 121 has certain requirements that must be met.

2-Q) what is Boot?

(A) "Boot" is a consideration, such as cash, non-like-kind property, notes, or reduction in mortgage (mortgage boot) given in addition to "like-kind" property in an exchange transaction. If you receive a boot in exchange, it's likely all, or some portion, of the boot will be taxed.

3-(Q) What happens if I sell a property and then decide I want to make it a part of a 1031 Exchange?

(A) If you actually or constructively received proceeds from the sale, it might not be possible to include that property in a 1031 Exchange. That's why it's important to note your intention to make this transaction part of a 1031 Exchange from the beginning, in the contract to sell the first property. If you have entered into a contract to sell, but have not closed, it may be possible to carry out a delayed exchange, provided you execute the proper exchange documents, identify the replacement property within 45 days of the closing, and actually receive it within 180 days or before your tax return is due. Your attorney or tax advisor can help to make that determination.

4-(Q) Is there an extension allowed to either the 45-day period or the 180-day period?

(A) The IRS does not allow extensions for either the 45-day period or the 180-day period.

5-(Q) If the Exchanger's 45th or 180th day falls on a weekend or holiday, do I get the benefit of the following business day?

(A) No. The IRS calculates this timeline based on calendar days. There are no extensions given.

6-(Q) What is the 45-day Identification Period and when does it begin?

(A) Section 1031 requires the replacement property to be identified within 45 days of closing on the relinquished property. This identification period is strictly enforced, and a violation will defeat the tax deferral.

7-(Q) What qualifies as a "material substantial contingency beyond the taxpayer's control?"

(A) The Regulations provide three narrow examples:

1) The replacement property is destroyed, seized, requisitioned, or condemned;
2) Regulatory approval is required for the transfer of the property, and it cannot be obtained on time;
3) An outside agency requires that the property be rezoned before a certain date thereby preventing compliance.

8-(Q) Do second homes qualify for exchanges?

(A) Yes, as long as the primary purpose for the second home is not for personal use. For example, let's say the taxpayer personally uses the property one or two weeks a year but then the property is rented much of the rest of the year. Excluding the percentage of the year the property is used personally, this property could, in fact, be exchanged. How much personal use will disqualify the property is uncertain. If you are contemplating such an exchange, we strongly urge you to contact a knowledgeable tax advisor before proceeding.

9-(Q) Are partnerships allowed to do exchanges?

(A) Yes, all tax-paying entities are entitled to the benefits of Section 1031.

10-(Q) Can I add money to the exchange and acquire an even more expensive piece of property than I am giving up?

(A) Yes

11-(Q) Do I have to spend all of the 1031 exchange proceeds?

(A) No, you do not have to reinvest 100% of the net sales proceeds, however, the amount that you do not reinvest will be subject to tax and the amount that you do reinvest will be tax-deferred.

12-(Q) What is an adjusted basis?

(A) Generally it is determined by taking the sales price when acquired cost of capital improvement less depreciation.

13-(Q) Who controls the proceeds?

(A) The proceeds must be held and controlled by a Qualified Intermediary, not by an agent, escrow, or related party which includes relatives.

14-(Q) How long do you have to find a replacement property?

(A) Identification must be received within 45 days of the close of the relinquished property.

15-(Q) **What property qualifies for a 1031 Exchange?**

(A) Relinquished and replacement properties must be property held for investment.

16-(Q) Can related parties exchange with each other?

(A) Yes. It is a complex issue; however, it deserves further explanation.

17-(Q) Who can Exchange?
(A) Corporations, Partnerships, Individuals, Trusts, Limited Liability Companies.

Tax Deferred Exchange Terminology

1. **<u>1031 Exchange</u>** – The tax-deferred sale and purchase of properties that are like-kind for the benefit of deferred gain treatment.

2. **<u>Alternative Minimum Tax</u>**- A method of calculating income tax that does not Allow certain deductions, credits, and exclusions. The alternative Minimum tax was devised to ensure that individuals, trusts, and estates that benefit from tax preferences do not avoid paying any federal income taxes.

3. **<u>Basis</u>** – The starting point for determining gain or loss in any transaction. In general, the basis is the cost of property.

4. **<u>Boot</u>** – Fair Market Value of non-qualified (not "like-kind") property received in an exchange. (Examples: cash, notes, seller financing, furniture, supplies, and reduction in debt obligations.) Receipt of a boot will not disqualify an exchange, but the boot will be taxed to the Exchanger to the extent of the recognized gain.

5. **<u>Cash Boot</u>** – Any proceeds actually or constructively received by the Exchanger.

6. **<u>Capital Gain Tax</u>**- Tax levied by Federal and state governments on investments that are held for a year or more. Investments may include real estate,

7. **<u>Delayed Exchange</u>** – An exchange that takes place within (a day up to 180 days) in between the initial sale and subsequent acquisitions.

8. **<u>Exchanger</u>** – The property owner(s) seeking to defer capital gain tax by utilizing an IRC 1031 exchange. (The Internal Revenue Code uses the term "Taxpayer".)

9. **<u>Exchange Agreement</u>** – The written agreement defining the transfer of the relinquished property. The subsequent receipt of the replacement property and the restrictions on the exchange proceeds during the exchange period.

10. **<u>Exchange Period</u>** - The period during which the Exchanger must acquire Replacement Property in the exchange. The Exchange Period starts on the date the Exchanger transfers the first Relinquished Property and ends on the earlier of the **180th** day thereafter or the due date (including extensions) of the Exchanger's tax return for the year of the transfer of the Relinquished Property.

11. **<u>Identification Period</u>** – The period during which the Exchanger must identify Replacement Property in the exchange. The Identification Period starts on the day the Exchanger transfers the first Relinquished Property and ends at midnight on the **45th** day thereafter.

12. **Like-Kind Property** – This term refers to the nature or character of the property, not its grade or quality. Generally, real property is “like-kind” as to all other real properties long as the Exchanger’s intent is to hold the properties as an investment or for productive use in a trade or business. With regard to personal property, the definition of “like-kind” is much more restrictive. (See Brief Exchange, Like-Kind Property)

13. **Mortgage Boot** – This occurs when the Exchanger does not acquire debt that is equal to or greater than the debt that was paid off on the relinquished property sale; referred to as “debt relief”. This can create a taxable event.

14. **Qualified Intermediary** – The entity that facilitates the exchange for the Exchanger. Although the Treasury Regulations use the term “Qualified Intermediary,” some companies use the term “facilitator” or “accommodator.”

15. **Realized Gain** – Refers to gain that is not yet taxed. In a successful exchange, the gain is realized.

16. **Recognized Gain** – Refers to the amount of gain that is subject to tax when a property is disposed of at gain or profit in a troubled transfer.

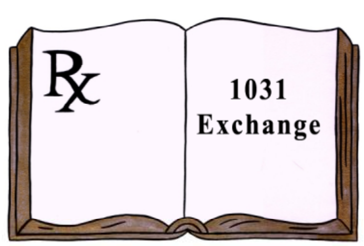
17. **Relinquished Property** – The property “sold” by the Exchanger. This is also sometimes referred to as the **“exchange”** property or the “down leg” property.

18. **Replacement Property** – The property acquired by the Exchanger. This is sometimes referred to as the **“acquisition”** property or the “up leg” property.

19. **Starker Exchange** – A term used to describe delayed non-simultaneous, exchanges, starker vs. United States (1979) established the delayed exchange concept.

20. Gain – The taxable portion of the sale price.

21. Goodwill-The value of business on continued customer patronage due to its name, reputation, or any other factor. The goodwill of a business is not. exchangeable under Internal Revenue Code Section 1031.



Test your knowledge!

1-Gain on 1031 Exchange is taxable:
A. always
B. never
C. sometimes

2- Can escrow officers advise clients about 1031 exchange legal matters?
A. always
B. rarely
C. sometimes
D. never

3- Capital losses are limited to what amount to offset ordinary income?
A. $30,000
B. $300,000
C. $13000
D. $3000

4- Is boot taxable?
A. never
B. rarely
C. always
D. sometimes

5- Under1031, improved real property can be exchanged for:
A. office building
B. industrial building
C. apartment
D. all the above

6-Tax Deferred exchanges have been around for how many years:
A. 55 years
B. 65 years
C. 75 years
D. over 85 years

7-An exchange must be completed not more than how many days after selling the old property?
A. 45 days
B. 90 days
C. 120 days
D. 180 days

8- Investment property can:
A. be exchanged under 1035
B. be exchanged with personal property.
C. be exchanged with stock and bonds
D. be exchanged under the 1031 exchange regulation

9- There are eight types of boots.
A. true
B. false

10-A delayed exchange is:
A. it is used all the times
B. never beneficial to the taxpayer
C. most often used
D. it is beneficial to the taxpayer

11- Your accountant can serve as a qualified intermediary.
A. true
B. false

12- Your attorney can serve as a qualified intermediary.
A. true
B. false

13- Forms 8824 is used to report:
A. capital gains tax
B. schedule c
C. 1120 corporation form
D . A like-kind exchange

14- Exchanges between related parties are:
A. illegal
B. prohibited
C. It is not possible
D. under certain circumstances is possible

15-Can you depreciate vacant land?
A. always
B. sometimes
C. often
D. never

16- What are the different types of exchanges?
A. delayed exchange, improvement exchange
B. reverse exchange, simultaneous exchange
C. personal property exchange
D. all the above

17-All exchange escrows must be completed within 60 days
A. true
B. false

18-Domestic property may be exchanged for foreign property under the 1031 rule
A. true
B. false

19-Goodwill of one business can be of a like kind to another business.
A. true
B. false

20-Real property and personal property are:
A. identical under 1031
B. like kind under 1031
C. not like-kind under 1031

21- The Tax Reform Act of 1984 prohibited the exchange of:
A. shopping center
B. vacant land
C. personal property
D. partnership interests

22-Investment property can:
A. be exchanged for personal property
B. be exchanged for car wash business
C. be exchanged for antique
D. be exchanged under the 1031 exchange

23- Exchange can increase:
A. estate tax
B. federal tax
C. sales tax
D. your leverage

24-Section 1031 exchange has been
A. modified five times
B. unchanged since 1921
C. changed only once in 1999
D. modified several times

25-Section 1031 does not eliminate the tax, but rather:

A. defers it for four years
B. splits it with family members
C. spreads it out over the term of the loan
D. postpones it until a later time

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