Dulles Area Association of REALTORS®
The Association of Choice for Real Estate Professionals™

Education
Earn Credit. Gain Credibility

1031 Exchanges:
What Realtors Need to Know

Student Handouts

I. Benefits

A. Benefits to Investors

1. **Defer capital gains tax**
2. **Leverage for wealth building**
3. **Diversification**
4. **Consolidation**
5. **Cash flow**
6. **Increase Depreciation**
7. **Management Relief**
8. **Estate planning**

B. Benefits to Realtors

1. **Two transactions = two commissions**
2. **More business for your clients**
3. **Stand out from the crowd**
4. **Tap into investor market**
5. **Little added work**
6. **No geographical limitations (in USA)**

II. Guidelines to remember

A. Consult CPA/Tax advisor
B. Demonstrate intent
C. Select a facilitator
D. Identify like-kind property
E. Watch the timelines (45-day and 180-day)
F. Obey identification rules (there are 3)
G. Remember replacement property requirements

III. The Rule: IRC Section 1031(a)

A. 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 <u>like kind</u> which is to be <u>held</u> either for productive use in a trade or business or <u>for investment</u>.

B. Remember that this is a "safe harbor"; in other words, if you obey the rule, your tax on capital gain is deferred—not eliminated, but deferred. However, if you do NOT obey the rule perfectly, it does not mean that your capital gain WILL be taxed—only that it <u>might</u> be.

IV. The holding period

A. The rule states that it concerns property "held . . . for investment." How long must property be held? The rule does not specify. Perhaps it should be held long enough to straddle two taxable periods?

V. The requirement of being "like-kind"

A. General rule": as long as it is real estate, it's OK. That includes the following:

1. Single/multi-family homes

2. Rentals

3. Office/commercial

4. Retail/industrial

5. Vacation rentals

6. Land

7. Leasehold interest of 30+ years

8. TIC interests

VI. Five Types of Exchanges

A. Delayed exchange (most common)
B. Simultaneous exchange (sale and purchase occur at the same time)
C. Reverse exchange (replacement property purchased prior to the sale of the relinquished property)
D. Improvement exchange
E. Personal property exchange

VII. Rules of identification of replacement property

A. 3 property rule
1. ID up to 3 properties of any value and close on one or more
B. 200% rule
1. ID 4 or more properties, combined value not over 200% of property sold and close on one or more
C. 95% Exception rule
1. ID any amount of properties, of any value, and MUST close on 95% of total amount identified

VIII. Delayed Exchange Timeline

A. Starting point: sale of Relinquished Property
B. 45 days to identify Replacement Property
C. 180 days to close on Replacement Property
D. NOTE: 45-day timeline and 180-day timeline run consecutively
E. WRINKLE: 180-day timeframe is not the whole story. It is really the earlier of (1) 180 days after relinquished property closing or (2) due date of transferor's tax return (determined with regard to extension). So watch your tax filing!

IX. Equal or greater rule

A. General rule: Replacement Property must have value equal to or greater than the Relinquished Property with respect to BOTH the equity and loan amount.

B. If the equity of the Replacement Property is less than the equity of the Relinquished Property, you wind up with taxable "cash boot".

C. If the loan amount of the Replacement Property is less than the loan amount of the Relinquished Property, you wind up with taxable "mortgage boot."

X. Suggested Contract Addendum

A. The parties recognize that this transaction is a 1031 Exchange. Seller agrees to cooperate in facilitating said exchange by signing whatever documents may be necessary to effect said exchange at no additional liability or cost to Seller.

XI. Special Rules

A. Transfers between related parties (siblings and lineal descendants and lineal ancestors): each party must hold for 2 years or more.

B. Reverse exchanges: the Replacement Property is acquired prior to the sale of the Relinquished Property and then "parked" by a third-party titleholder

C. Vacation homes: qualify for 1031 treatment when used less than 14 days or 10% of the time it is rented out.

Appendix A **http://www.irs.gov/uac/Like-Kind-Exchanges-Under-IRC-Code-Section-1031**

XII. Like-Kind Exchanges Under IRC Code Section 1031

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WASHINGTON — Whenever you sell business or investment property and you have a gain, you generally have to pay tax on the gain at the time of sale. IRC Section 1031 provides an exception and allows you to postpone paying tax on the gain if you reinvest the proceeds in similar property as part of a qualifying like-kind exchange. Gain deferred in a like-kind exchange under IRC Section 1031 is tax-deferred, but it is not tax-free.

The exchange can include like-kind property exclusively or it can include like-kind property along with cash, liabilities and property that are not like-kind. If you receive cash, relief from debt, or property that is not like-kind, however, you may trigger some taxable gain in the year of the exchange. There can be both deferred and recognized gain in the same transaction when a taxpayer exchanges for like-kind property of lesser value.

This fact sheet, the 21st in the Tax Gap series, provides additional guidance to taxpayers regarding the rules and regulations governing deferred like-kind exchanges.

Who qualifies for the Section 1031 exchange?

Owners of investment and business property may qualify for a Section 1031 deferral. Individuals, C corporations, S corporations, partnerships (general or limited), limited liability companies, trusts and any other taxpaying entity may set up an exchange of business or investment properties for business or investment properties under Section 1031.

What are the different structures of a Section 1031 Exchange?

To accomplish a Section 1031 exchange, there must be an exchange of properties. The simplest type of Section 1031 exchange is a simultaneous swap of one property for another.

Deferred exchanges are more complex but allow flexibility. They allow you to dispose of property and subsequently acquire one or more other like-kind replacement properties.

To qualify as a Section 1031 exchange, a deferred exchange must be distinguished from the case of a taxpayer simply selling one property and using the proceeds to purchase another property (which is a taxable transaction). Rather, in a deferred exchange, the disposition of the relinquished property and acquisition of the replacement property must be mutually dependent parts of an integrated transaction constituting an exchange of property. Taxpayers engaging in deferred exchanges generally use exchange facilitators under exchange agreements pursuant to rules provided in the Income Tax Regulations. .

A reverse exchange is somewhat more complex than a deferred exchange. It involves the acquisition of replacement property through an exchange accommodation titleholder, with whom it is parked for no more than 180 days. During this parking period the taxpayer disposes of its relinquished property to close the exchange.

What property qualifies for a Like-Kind Exchange?

Both the relinquished property you sell and the replacement property you buy must meet certain requirements.

Both properties must be held for use in a trade or business or for investment. Property used primarily for personal use, like a primary residence or a second home or vacation home, does not qualify for like-kind exchange treatment.

Both properties must be similar enough to qualify as "like-kind." Like-kind property is property of the same nature, character or class. Quality or grade does not matter. Most real estate will be like-kind to other real estate. For example, real property that is improved with a residential rental house is like-kind to vacant land. One exception for real estate is that property within the United States is not like-kind to property outside of the United States. Also, improvements that are conveyed without land are not of like kind to land.

Real property and personal property can both qualify as exchange properties under Section 1031; but real property can never be like-kind to personal property. In personal property exchanges, the rules pertaining to what qualifies as like-kind are more restrictive than the rules pertaining to real property. As an example, cars are not like-kind to trucks.

Finally, certain types of property are specifically excluded from Section 1031 treatment. Section 1031 does not apply to exchanges of:

- Inventory or stock in trade
- Stocks, bonds, or notes
- Other securities or debt
- Partnership interests
- Certificates of trust

What are the time limits to complete a Section 1031 Deferred Like-Kind Exchange?

While a like-kind exchange does not have to be a simultaneous swap of properties, you must meet two time limits or the entire gain will be taxable. These limits cannot be extended for any circumstance or hardship except in the case of presidentially declared disasters.

The first limit is that you have 45 days from the date you sell the relinquished property to identify potential replacement properties. The identification must be in writing, signed by you and delivered to a person involved in the exchange like the seller of the replacement property or the qualified intermediary. However, notice to your attorney, real estate agent, accountant or similar persons acting as your agent is not sufficient.

Replacement properties must be clearly described in the written identification. In the case of real estate, this means a legal description, street address or distinguishable name. Follow the IRS guidelines for the maximum number and value of properties that can be identified.

The second limit is that the replacement property must be received and the exchange completed no later than 180 days after the sale of the exchanged property or the due date (with extensions) of the income tax return for the tax year in which the relinquished property was sold, whichever is earlier. The replacement property received must be substantially the same as property identified within the 45-day limit described above.

Are there restrictions for deferred and reverse exchanges?

It is important to know that taking control of cash or other proceeds before the exchange is complete may disqualify the entire transaction from like-kind exchange treatment and make ALL gain immediately taxable.

If cash or other proceeds that are not like-kind property are received at the conclusion of the exchange, the transaction will still qualify as a like-kind exchange. Gain may be taxable, but only to the extent of the proceeds that are not like-kind property.

One way to avoid premature receipt of cash or other proceeds is to use a qualified intermediary or other exchange facilitator to hold those proceeds until the exchange is complete.

You can not act as your own facilitator. In addition, your agent (including your real estate agent or broker, investment banker or broker, accountant, attorney, employee or anyone who has worked for you in those capacities within the previous two years) can not act as your facilitator.

Be careful in your selection of a qualified intermediary as there have been recent incidents of intermediaries declaring bankruptcy or otherwise being unable to meet their contractual obligations to the taxpayer. These situations have resulted in taxpayers not meeting the strict timelines set for a deferred or reverse exchange, thereby disqualifying the transaction from Section 1031 deferral of gain. The gain may be taxable in the current year while any losses the taxpayer suffered would be considered under separate code sections.

How do you compute the basis in the new property?

It is critical that you and your tax representative adjust and track basis correctly to comply with Section 1031 regulations.

Gain is deferred, but not forgiven, in a like-kind exchange. You must calculate and keep track of your basis in the new property you acquired in the exchange.

The basis of property acquired in a Section 1031 exchange is the basis of the property given up with some adjustments. This transfer of basis from the relinquished to the replacement property preserves the deferred gain for later recognition. A collateral affect is that the resulting depreciable basis is generally lower than what would otherwise be available if the replacement property were acquired in a taxable transaction.

When the replacement property is ultimately sold (not as part of another exchange), the original deferred gain, plus any additional gain realized since the purchase of the replacement property, is subject to tax.

How do you report Section 1031 Like-Kind Exchanges to the IRS?

You must report an exchange to the IRS on Form 8824, Like-Kind Exchanges and file it with your tax return for the year in which the exchange occurred.

Form 8824 asks for:

- Descriptions of the properties exchanged
- Dates that properties were identified and transferred
- Any relationship between the parties to the exchange
- Value of the like-kind and other property received
- Gain or loss on sale of other (non-like-kind) property given up
- Cash received or paid; liabilities relieved or assumed
- Adjusted basis of like-kind property given up; realized gain

If you do not specifically follow the rules for like-kind exchanges, you may be held liable for taxes, penalties, and interest on your transactions.

Beware of schemes

Taxpayers should be wary of individuals promoting improper use of like-kind exchanges. Typically they are not tax professionals. Sales pitches may encourage taxpayers to exchange non-qualifying vacation or second homes. Many promoters of like-kind exchanges refer to them as “tax-free” exchanges not “tax-deferred” exchanges. Taxpayers may also be advised to claim an exchange despite the fact that they have taken possession of cash proceeds from the sale.

Consult a tax professional or refer to IRS publications listed below for additional assistance with IRC Section 1031 Like-Kind Exchanges.

References/Related Topics

- Publication 544, Sales and Other Dispositions of Assets
- Form 8824, Like-Kind Exchanges (PDF)
- Form 4797, Sales of Business Property

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Appendix B Frequently Asked Questions

http://www.orexco1031.com/Resources/FAQ.aspx?nav=resources&nav2=faq

What does the term 1031 refer to?
1031 is the number assigned to the Internal Revenue Code Section that provides for the tax deferred exchange of real and personal property.

What does the term Starker refer to?
It refers to the landmark 1979 federal case entitled, *Starker v. U.S.* 602 F2d 1341 (9th Cir 1979) wherein the court substantiated the validity of the delayed exchange process. Prior to the Starker case, the courts had never sanctioned an exchange whereby the relinquished property was sold and - at a later date - the replacement property was purchased.

What are “Safe Harbors”?
This term refers to the rules established by the 1991 Treasury Regulations for tax deferred exchanges which provide that - if followed - the IRS will allow the exchange to qualify.

Why is the tax deferred exchange a popular financial planning tool?
If done correctly, investors defer tax due in connection with the sale of real or personal property, enabling them to access their equity to consolidate, diversify, leverage or relocate their investments.

Why use a Qualified Intermediary?
Use of a Qualified Intermediary is sanctioned as a safe harbor by the IRS.

What is like kind?
Real or personal property of the same nature or quality is like kind. Generally, real property is like kind to all other real property, except foreign real property, as long as it is held for investment or for the productive use in a trade or business. Personal Property must be either the same General Asset Class or Product Class.

How do I properly identify my replacement property?
Property is properly identified only if you unambiguously described it in a written document signed by you and hand delivered, mailed, telecopied, or otherwise sent to the person obligated to transfer the replacement property to you (i.e. the Qualified Intermediary or the seller of the replacement property) or to any other person “involved in the exchange” other than you or a person disqualified under Treas. Reg. Section 1.1031(k)-1(k). Real property generally is unambiguously described if it is described by a legal description, street address, or distinguishable name (e.g. the Mayfair Apartment Building). If at the end of the identification period - 45 days - you identified more properties than permitted by IRC Section 1031 (k)-1(b)(1) it is treated as if no replacement property has been identified and the exchange will be disallowed.

What are the 45 and 180 day deadlines?
Beginning with the close of the Relinquished Property, you have 45 days to identify the properties you intend to purchase and 180 days (or the due date for your tax return - whichever is earlier) to complete the acquisition of those properties. In addition, the 45-day identification period and the 180 day exchange period are calendar days. If the 45th day or 180th day falls on a weekend or holiday, the deadlines still apply. There are no extensions for Saturdays, Sundays, or legal holidays.

Is there any way to get an extension on the 45 day or 180 day deadlines?
No extensions are allowed on the 45-day deadline. Your written identification notice must be signed and dated and sent on or before midnight of the 45th day after the Relinquished Property closing. With respect to the exchange period, it ends on the earlier of the 180th day after the Relinquished Property closing or the due date (including extensions) of your tax return for the taxable year in which the transfer of the relinquished property occurred. Thus, if the exchange period is cut short by the earlier occurrence of your tax filing date, you may file for an extension in order to get the full 180-day exchange period.

What is Boot?
Broadly defined, boot is considered:

1. "Cash boot" - money received (or not reinvested) by you during an exchange. If you carry a note for your buyer, the note is also considered cash boot.
2. "Mortgage boot" occurs when you pay off a loan on the sale of the relinquished property but do not either get a loan for equal or greater value when you buy the replacement property or invest additional cash equal to your debt relief. In other words, if you choose not to get a loan on the replacement property, it is perfectly acceptable to simply come up with the additional cash required to purchase the replacement property.
3. Any type of replacement property received that is not like kind.

If I own a property with another investor, can I exchange my equity if he doesn't want to?
Yes. You would want to clearly allocate each investor's interest in the property before you sell. The investor who wishes to exchange may do so, and the other investor may receive cash (taxable). It is, however, very important that the investors be clear on their intentions before entering into an exchange agreement with a Qualified Intermediary. Once a Relinquished Property is closed where all investor parties are under one exchange agreement, they do not have an option of dividing proceeds and buying separate Replacement Properties.

What is a partial tax exchange?
If the equity in your investment property is $150,000 and you wanted to use only $100,000 to purchase your replacement property and take $50,000 out to buy a new car, you would have a partially tax deferred exchange. The $50,000 cash you took to purchase the car is considered taxable cash boot.

May I take out my basis and reinvest only the gains?
No. Both basis and gains must be reinvested to defer taxes. The IRS does not allow you to allocate a portion of the money as basis and a portion as gain. Any money received by you will be considered boot and taxed at a capital gain rate.

Can a carry-back note, drawn in the name of the Exchanger, be assigned to the Qualified Intermediary as part of an Exchange?
No. Once the Note is received in your name, it will be taxable boot. Alternatively, to use the note as part of the 1031 exchange, the note and deed of trust must be drawn in the Qualified Intermediary's name.

What is the net value of the property?
Simply stated, the net value is your sales price less your closing costs. You are responsible for

reinvesting both the cash and the loan amount when you purchase the replacement property. (See section on Boot.)

How does the note become part of the exchange?
The note must be drawn in the name of the Qualified Intermediary. During the 180-day exchange period, you have several options in using the note as part of the exchange:

1. Sell the note to a buyer and liquidate it to cash that is then added to the exchange proceeds and applied to the purchase price of the replacement property;
2. Obtain the agreement of the replacement property seller to accept the note as part of the purchase price to be paid for the replacement property;
3. Accept only a short-term note (i.e. due in less than 6 months) that will be paid off in full prior to the acquisition of the replacement property. Payments received are added to the exchange funds and used to purchase the replacement property.

I own a piece of property that has my own primary residence as well as a rental unit, would it still qualify for an exchange?
Yes, so long as you remain consistent with your past tax returns. Consult with your tax advisor to determine the percentage of the value of the property you have attributed to investment. You may exchange that portion of the value.

How long must I hold a property for investment before I can move into it for my own residence?
The IRS has never established any rule for a required holding period for investment property to qualify under IRC Section 1031. If you are considering converting investment property to a principal residence, we strongly recommend that you consult with your tax advisor.

What does the term "disqualified party" refer to?
The 1994 Treasury Regulations provide that certain persons/entities are disqualified from acting as a Qualified Intermediary. Disqualified persons include anyone who can be considered your agent, anyone who is a related person as defined in the Code, or anyone who bears a relationship as your agent as described in the Code. Your agents include anyone who has acted as your employee, attorney, accountant, investment banker, real estate agent or broker within the previous two years.

Do I have access to my money during the exchange?
During the exchange transaction your exchange proceeds are placed in an exchange trust account so that you do not have actual or constructive receipt of the funds. If you have not identified property, you may not receive the exchange funds until after the expiration of the 45th day. If, however, you have identified property but you later decide not to exchange you may not have access to the funds until the expiration of the 180-day exchange period. (Some limited exceptions apply.)

What are exchange expenses?
Certain customary expenses incurred in selling the property, which include but are not limited to the real estate commission, exchange fees, legal fees and transfer taxes, may be paid with exchange proceeds thereby reducing the amount that must be reinvested in the replacement property.