

In the Know...

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IN A NUTSHELL

THE TAX DEFERRED EXCHANGE - In A Nutshell

The tax deferred exchange, as defined in Section 1031 of the Internal Revenue Code offers investors one of the last opportunities to build wealth, leverage their investments and save taxes. In completing an exchange, the investor (Exchanger/Taxpayer) can dispose of their investment real property or personal property, use all of the equity to acquire replacement investment property, use someone else's funds such as an institutional lender, defer the capital gain tax that would ordinarily be owed, and leverage their equity into replacement properties. In order to accomplish a FULL tax deferred exchange the Exchanger must replace their Value, Equity and Debt from the property being sold (Relinquished Property) to the property being purchased (Replacement Property).

When an exchange is deemed appropriate for the Exchanger, the Exchanger must enter into the exchange transaction prior to the close of the Relinquished Property. An Exchange Agreement is prepared by the Qualified Intermediary based on the Sale Contract provided by the Exchanger. This agreement must be signed by the Exchanger and the Qualified Intermediary prior to the closing of the Relinquished Property. The Exchange Agreement requires that (1) the Qualified Intermediary acquires the relinquished property from the Exchanger and transfers it to the buyer by direct deed from the Exchanger and (2) the Qualified Intermediary acquires the replacement property from the seller and transfers it to the Exchanger by direct deed from the seller. The proceeds from the relinquished property are assigned to the Qualified Intermediary and are held by the Qualified Intermediary in a separate, financially secured account. The balance of exchange funds are used by the Qualified Intermediary to purchase the Replacement Property for the Exchanger.

SOME CONSIDERATIONS WHEN DOING AN EXCHANGE

Exchanges are tied to a strict timeline dictated by the IRS 1031 code. The Exchanger has 45 days from the date the relinquished property closes to identify potential replacement properties. The identification is done by a written document and sent to the Qualified Intermediary. The identification must contain the addresses or legal descriptions of the potential replacement properties. If any of the properties are new construction the identification must be completed by using the legal description (not property address) of the property being purchased AND a detailed description of the improvements to be constructed thereupon AND the fair market value of the property (as of the date of purchase) must be included in the ID document. The replacement property must be purchased within 180 days after the close of the relinquished property. Once the 45 days has passed, the Exchanger can not change their Property Identification and is limited to purchasing the properties listed on the identification. The exchange will fail if the exchanger purchases, with the exchange funds, any property which has not been properly identified by exchanger.

In attempting to defer capital gain taxes the Exchanger should follow three general rules: (1) purchase a replacement property that is equal to or greater in value as the relinquished property,

(2) purchase a replacement property that is equal to or greater in equity as the relinquished property and have the same or greater debt on the replacement property as on the relinquished property. The Exchanger, should they choose, can avoid debt relief (which happens if debt is not replaced in the new property) by a cash boot to the replacement property (aside from the exchange funds being held by the Qualified Intermediary) equivalent to the debt paid off at the closing of the Relinquished Property.



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The Exchanger must sell property that is held for income or investment purposes and acquire replacement property (new to Exchanger) that is to be held for income or investment purposes.

IRC Section 1031 does not apply to exchanges of stock in trade, inventory, stocks, bonds, notes, securities, evidences of indebtedness, certificates of trust or beneficial interests, or interests in a partnership.

If the Exchanger holds non-depreciable property, raw land, for example, and exchanges the property for depreciable replacement property, or the replacement property has a higher ratio of depreciable fair market value to total fair market value than the ratio of the relinquished property(ies) depreciable tax basis to total tax basis, the taxpayer will obtain a benefit from shifting the substituted tax basis from non-depreciable property to depreciable property. This will result from the basis allocation of the replacement property in accordance with the fair market value of its components.

EXCHANGE TERMINOLOGY

1. Qualified Intermediary: The entity that is hired, by the Exchanger, to facilitate the exchange. This entity is often times referred to as Accommodator, Facilitator, or Qualified Intermediary.

2. Exchanger: The Taxpayer/Seller of property . This person is the party that desires to defer capital gains taxes through the use of an IRC Section 1031 Exchange. The tax code 1031 refers to this person as the Taxpayer.

3. Constructive Receipt: This term refers to the control of proceeds by an Exchanger whether the Exchanger has physical possession of the funds or not. Any time the IRS can deem that the Exchanger has either constructive receipt or actual possession of the funds from the sale of the Relinquished Property then a capital gain is due to the IRS.

4. Like-Kind Property: This term refers to the nature or character of the property, not its grade or quality. This term has been and can be misleading to Exchanger's. Often it is believed that if you sell commercial property you must purchase commercial property, vacant land for vacant land however, real property is "like-kind" as to all other real property as long as the intent is to hold the properties is for investment purposes or for productive use in a trade or business. Personal Property can also be exchanged for other personal property, however the requirements for "like kind" as it relates to personal property is far more restrictive. An example is that if you sell a bull you must replace with a bull not a cow. Please contact our office for further guidelines regarding personal property exchanges.

5. Relinquished Property: The property "sold" by the Exchanger. Prior to the 1991 amendment of the Section 1031 code this was often referred to as the "down-leg" of the exchange.

6. Replacement Property: The property "acquired" by the Exchanger. Prior to the 1991 amendment to Section 1031 code this was often referred to as the "up-leg" of the exchange.

7. Identification Period: 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.

8. Exchange Period: The time period during which the Exchanger must acquire Replacement Property. 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 in which the transfer of the Relinquished Property took place. If this date falls on a weekend or a holiday you will have to fall back to the prior business day, in which case you will have less than 180 days.

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What Property Qualifies

To qualify for a tax deferred exchange under IRC Section 1031 both the relinquished and the replacement properties must be held by the Exchanger for investment purposes or for productive use in a trade or business. The intent of holding the property, rather than the type of property, is the critical issue.

The following are some examples of qualifying properties:

- Raw/Vacant lands
- Commercial /Industrial rental property
- 30-year leasehold interest
- Farmland (may be necessary to do both a personal and real property exchange)
- Residential rental
- Doctor's own office (may be necessary to do both a personal and real property exchange)

What Property Does Not Qualify

Under IRC 1031 the following properties do not qualify for exchange purposes:

Stock in trade or other property held primarily for sale (Note: this includes properties held by a developer or other dealers of property, primary residences' check with your CPA regarding your status);

- ↔⊕⊗ Securities or other evidences of indebtedness or interest;
- ↔⊕⊗ Stocks, bonds, or notes;
- ↔⊕⊗ Certificates of trust or beneficial interests;
- ↔⊕⊗ Interests in a partnership (Note: the partnership can elect out of partnership status using IRC 761(a) see your CPA regarding your complete options);
- ↔⊕⊗ Chooses in action (a right to receive money or other personal property by judicial proceeding).

Keys to a Successful Exchange

IRC Section 1031 states that:

No gain... shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind...

To qualify, the following requirements must be met:

There must be at least two properties in an exchange. The properties being exchanged must "qualify":

- ↔⊕⊗ They must be held for use in trade or business (e.g., office building, warehouse, industrial space, farmland, retail building) or for investment (e.g., raw land, rental home/apartment/ condo). The properties that you are exchanging do not have to be identical. All of the above examples are "like kind" in nature, so you can exchange land for warehouse, office for rental home, etc.
- ↔⊕⊗ Property that you own for personal use (e.g., your primary residence) does not qualify for a 1031 exchange.

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To defer ALL of your capital gains:

- ↔ⓈⓂ The purchase price of your replacement property(s) must be equal to or greater than the sales price of your relinquished (sold) property(s).
- ↔ⓈⓂ All of your sale equity (cash) must be reinvested in the replacement property(s).
- ↔ⓈⓂ Any debt you had on your relinquished (sold) property(s) must be replaced with a debt of equal or greater value or offset with additional cash boot.

You **MUST** use a *Qualified Intermediary (Accommodator)*

The IRS will not allow you to receive cash proceeds or take "constructive receipt" of the funds in any way, or else you will be taxed.

It is the accommodator who legally sells Property A to buy replacement Property B on behalf of the client, creating an exchange of properties. The client has the freedom to identify what he wants to sell and what he wants to replace it with, but the accommodator is the legal vehicle through which the properties are transferred.

The accommodator guides the 1031 process and provides appropriate documentation that enables qualification. Most importantly, the accommodator must be totally independent: he cannot provide tax, legal, or financial advice to you.

Failure to meet any of these key deadlines may disqualify the exchange:

Prior to closing on the relinquished property: demonstrate intent to perform an exchange through a written agreement with the accommodator.

Within 45 days (the ID Period) from the closing date on the relinquished property:

Identify one or more potential replacement properties.

Identification Rules: Up to 3 potential properties, no matter what their value 200% Rule, any number of properties, but the total value cannot exceed twice the value of the relinquished property, or 95% Rule: any number of properties, but must close on 95% of the aggregate value of those identified properties.

Within 180 days from the closing date on the relinquished property: acquire one or more of the replacement properties which have been identified during the ID Period. (if straddling a tax year you may need to file an extension to allow for the full 180 days)

Common Questions

What is basis?

In general, basis is the initial value of the original property, increased by capital expenditures and decreased by allowable depreciation or cost recovery. It is used to calculate the amount of capital gain you will realize. Yes, it is complicated, and you should consult with your tax advisor.

How can I know if I have qualifying property to exchange?

Generally, any property held for investment or used in trade or business qualifies.

What would not qualify as property that could be exchanged?

Stock in trade (inventory), stocks and bonds, REIT stocks, other securities, interest in a partnership, certificates of trust.

Regarding personal residences, can I use the 1031 exchange?

No. If you are now living in the home you are selling or if you plan to live in the replacement property, it will not be a valid 1031 exchange. However, there are other very liberal tax-break rules if you have lived in the home you are selling. Consult your tax advisor.

Can you give me a little more information regarding held for investment?

Here is an example: if you bought a house and moved into it, it would not be considered for investment purposes. However, if you rented the house out to others, then it would qualify. The lease must be long enough to show investment intent. Land held for appreciation also qualifies.

But what if I leased it out to my son or other relative?

It is OK as long as this is an arm's-length transaction (for example, having a signed lease and having him pay fair market rent).

Can I live in one unit of a multi-unit apartment house that I acquire?

Yes, but allocating values between personal and investment portions will be essential.

"Boot" is taxable, right?

Boot is cash or other non-qualifying (not like-kind) property received ("carried back") in an exchange. here is cash boot and also mortgage boot. Both are taxable, so please talk with your tax advisor.

Answers to Some Common Questions

The following are many of the most frequently asked questions about IRC Section 1031 tax deferred exchange. We cannot cover the subject completely here, but we want to give you a brief overview of this great wealth-building tool. There are still some undecided areas of the exchange law, and many different interpretations; there are also areas of ambiguity, so we cannot guarantee our answers will apply in all situations. However, we recommend you review the following, especially if you have an interest in going forward with an IRC Section 1031 exchange.

Where did 1031 come from and what does it really mean?

Section 1031 is merely that number assigned to the Internal Revenue Code (IRC) section that deals with tax-deferred exchanges.

Has this been available very long?

Yes. It goes as far back as the 1920s. Changes have been made and the Treasury has formally clarified many aspects of this Code. These clarifications helped to make exchanges very popular.

If my property is in California, can I trade it for property in another state?

Yes. 1031 exchanges are applicable anywhere in the U.S. (and the U.S. Virgin Islands). Foreign properties do not qualify. But be advised, some states have special rules affecting exchanges in their state only.

So, again please, what is the biggest advantage of doing a 1031 exchange?

By deferring tax, you have more money in hand to invest in another property. In effect, you receive an interest-free loan from the government, in the amount you would have paid in taxes. A wonderful estate builder indeed.

Now that the capital gains tax has been reduced, does it still pay to do a 1031 exchange?

You bet! The federal government will tax 15% of your gains (or more) and some states take an additional tax bite. With a 1031 exchange, you defer those taxes. Always check with your tax consultant before doing any exchange to ascertain your particular tax benefits.

Could I be better off selling my property and paying capital gains tax?

Each person's financial situation is different. You and your tax advisor should do a tax calculation to measure the benefit of doing an exchange. If you want to recognize a gain (or take a loss), you may choose to do a partial exchange or none at all. Check with your tax consultant.

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Isn't tax-deferred the same thing as tax-free?

No. In a 1031 exchange, you defer paying the capital gains taxes on your relinquished property. Its tax basis is carried over to the replacement property. When you finally sell the replacement property, without doing an exchange, you will pay the tax at that time. However, you may repeat this deferral process over and over again, from property to property, over a period of years.

But isn't there a way to avoid the tax completely in a 1031 exchange?

Only if you hold the property until death. Under current law, the stepped-up basis that your heirs would inherit on your property would eliminate the taxes on a gain.

Above, you refer to basis. What is that?

In general, basis is the initial value of the original property, increased by capital expenditures and decreased by allowable depreciation or cost recovery. It is used to calculate the amount of capital gain you will realize. Yes, it is complicated, and you should consult with your tax adviser.

What would not qualify as property that could be exchanged?

Stock in trade (inventory), stocks and bonds, REIT stocks, other securities, interest in a partnership, certificates of trust.

LEVERAGE EXCHANGE GROUP, LLC by law cannot provide legal or tax advice. You should always consult your legal/tax advisors regarding your unique circumstances.