1031 EXCHANGE BASICS

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The 1031 Exchange is commonly used tool for real estate investors to defer taxes on gain in the sale of a property. This type of sale can be utilized in transactions involving business or investment properties. Derived from the Internal Revenue Service's code Section 1031, the exchange is described as such:

> *An investor can postpone the tax consequences of selling their property when purchasing another property for the same use. To defer all taxes otherwise due upon sale, the aggregate fair market value of all replacement property received must be equal to or greater than the aggregate fair market value of all relinquished property. If you trade down in either equity or debt, the difference may be taxable to the extent of your gain.*

Reasons for Exchanging include:

- Deferring taxes on gains allows the investor to reinvest more money from the sale into the next property
- Consolidation of several smaller properties into one larger investment to facilitate management or improved cash flow
- Shifting investment from one area, locale or type of asset to another to take advantage of local market opportunities
- Avoiding "deferred maintenance," and the associated capital investment, by trading out the older properties into newer ones
- Diversification of investment portfolios by trading out of a single property, or type of property, into various investments or multiple properties

Specific guidelines should be followed to qualify for a 1031 Exchange. Investors are encouraged to seek legal and tax advice prior to beginning the process

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1031 EXCHANGE COMMON TERMS:

Exchanger:
The investor involved in a 1031 Exchange

Like Kind:
Properties are of like-kind if they are of the same nature or character, even if they differ in grade or quality

Relinquished Property:
The property the exchanger is selling

Replacement Property:
The property the exchanger acquires

Qualified Intermediary:
(QI) or Accommodator - an uninvolved third party who does any buying of replacement property or selling of the relinquished property necessary on behalf of the exchanger and holds the funds in escrow since the rules to an exchange disallow the investor from having access to the funds in interim.

Disqualified Person:
May not be Qualified Intermediaries. A Disqualified Person is any party who has acted as your agent, employee, attorney, accountant, investment banker/broker, or real estate agent or broker within the two-year period ending on the date of the first transfer of any relinquished property. Also disqualified are the family members of the Disqualified Persons, as well as partnerships, corporations and other entities in which you, or your related party, own directly or indirectly, more than a 10% interest.

Safe Harbor:
An accounting method that avoids legal or tax regulations

Identification Period:
The time frame (45 days from the closing on the relinquished property) the Exchanger has to identify the replacement property

Exchange Period:
The period in which the replacement property must be received (180 days after the closing of the relinquished property).

Boot:
Taxable income received from a 1031 Exchange

Types of 1031 Exchanges:

Simultaneous Exchange - The investor will close on their relinquished property and immediately after close on their replacement property, usually within one business day. An investor may or may not use a Qualified Intermediary to handle the funds, although it is not required.

Deferred or Delayed Exchange - Another method allows the investor to close on the relinquished property, then identify and close on the replacement property within 180 days. It requires a Qualified Intermediary. The replacement property must be identified within 45 days from the closing on the relinquished property.

Build-to-Suit (Improvement or Construction) Exchange - This technique allows the taxpayer to build on, or make improvements to, the replacement property, using the exchange proceeds.

Reverse Exchange - The exchanger acquires the replacement property before conveying the relinquished property. These are used when individuals wish to exchange property they own for property which must be purchased prior to the sale of the relinquished property.

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1031 EXCHANGE CHECKLIST AND DOCUMENTATION REQUIREMENTS

1. _____ Taxpayer adds Addendum to buyer's offer to show that transaction is a like kind exchange and to allow contract to be assigned to Qualified Intermediary.
2. _____ A copy of the sales contract is sent to the QI with the name and phone number of the settlement agent/attorney.
3. _____ Taxpayer signs QI provided Exchange and Escrow Account Agreement and Assignment of Contract prior to settlement. Signed documents are returned to QI. Written notification of assignment is provided to all parties of the contract prior to settlement.
4. _____ At settlement, QI receives exchange funds and places in qualified escrow account. Taxpayer has no control of funds.
5. _____ Within 45 days of transfer, taxpayer provides signed written notification to QI listing identified replacement properties.
6. _____ Taxpayer adds to replacement property contract Addendum to show transaction is part of a tax deferred exchange and that taxpayer's/exchanger's rights may be assigned.
7. ____ Taxpayer's rights in the replacement property contract are assigned to QI prior to settlement and written notification of assignment is provided prior to settlement to all parties of the contract.
8. ____ Within 180 days of transfer of first relinquished property, Taxpayer must receive replacement property.
9. ____ At the end of the exchange period, QI provides any remaining escrow account funds and interest earned to Taxpayer.
10. ____ Taxpayer/Exchanger files IRS Form 8824 for tax year in which first relinquished property was transferred.

Properties not Available for 1031 Exchange:

- Real Property located within the United States is no longer like-kind with Real Property located outside of the United States
- Personal Residence, unless it has been a rental property for 2 years
- Stock in trade or other property held primarily for sale
- Stocks, Bonds, Notes or other Securities or Evidence of Indebtedness or Interest
- Interests in a Partnership
- Certificates of Trust or Beneficial Interest
- Chose in Action - right to possession of something that can only be obtained or enforced through legal action
- Land which was acquired for the express purpose of subdivision and resale and only held long enough to effect such subdivision and resale
- Homes held for sale by speculation builders, such as builder's inventory of unsold homes

RULES TO IDENTIFYING THE REPLACEMENT PROPERTY

There are three rules that limit the number of properties that can be identified. The taxpayer must meet the requirements of at least one of these rules:

- **3-Property Rule:** The taxpayer may identify up to three potential replacement properties, without regard to their value; or
- **200% Rule:** Any number of properties may be identified, but their total value cannot exceed twice the value of the relinquished property;

or

- 95% Rule: The taxpayer may identify as many properties as he wants, but before the end of the exchange period, the taxpayer must acquire replacement properties with an aggregate fair market value equal to at least 95% of the aggregate fair market value of all the identified properties.

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