§ 1031 Tax Deferred Exchanges

A More Detailed Look

A reference guide encompassing all
aspects of the § 1031 Tax Deferred Exchange.

The information contained inside is compliments of:

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Look for link titled: Internal Revenue Bulletin 2010-12

What is a § 1031 Tax Deferred Exchange?

Section 1031 of the IRS Code reads as follows:

> ***§1031. Exchange of property held for productive use or investment***
> ***(a) Non-recognition of gain or loss from exchanges solely in kind. ––***
> ***(1) In general. ––*** *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 like kind which is to be held either for productive use in a trade or business or for investment.*

Simply put, a § 1031 Tax Deferred Exchange allows you to dispose of investment properties and acquire “like-kind” properties while deferring federal capital gains taxes. It allows you to reinvest sales proceeds that would otherwise be paid to the government in the form of taxes.

How does the IRS define “investment property”?

"...of property held for productive use in a trade or business or for investment..."

This phrase tells us that only property with certain characteristics, which we have called "income or investment property," will qualify for non-recognition treatment under § 1031.

For example, an exchange of the taxpayer's personal residence doesn't qualify for non-recognition treatment. (See, however, Internal Revenue Code § 121, "Exclusion of gain from sale of principal residence.")

A taxpayer's "stock in trade or other property held primarily for sale" doesn't qualify for non-recognition treatment. (See 26 United States Code § 1031(a)(2)(A).)

This exception to non-recognition treatment may be, at least for some taxpayers, difficult to interpret.

For example, a taxpayer owning ten acres of raw land may assume that his property will qualify for non-recognition treatment as "held for investment." But if the taxpayer subdivides the land into 20 lots, to increase its value, does the land then become "stock in trade" or "held primarily for sale," so as to bring it within this exception making it unqualified for non-recognition treatment? The answer may depend on other factors, such as whether the taxpayer has actively marketed or sold any subdivided lots before doing an exchange with unsold lots.

Taxpayers may be comforted to know that the IRS has not been overly aggressive in using this exception to disqualify exchanges involving land which has been subdivided or improved by the taxpayer prior to an exchange. The exception most clearly applies to developers seeking to exchange unsold inventory of homes or condominium units, but in less obvious cases where this exception might conceivably apply the taxpayer should proceed only with the assistance of a qualified tax advisor.

For further discussion of this exception, see Long and Foster, *Tax-Free Exchanges Under § 1031*, published by Clark-Boardman-Callaghan (Customer Service: 1-800-328-4880), 2001, § 2:05

A taxpayer's interest in stocks, bonds or notes does not qualify for non-recognition treatment. (See 26 United States Code § 1031(a)(2)(B).)

A taxpayer's interest in a partnership doesn't qualify for non-recognition treatment, even if the sole asset of the partnership is income or investment real property which itself would qualify for non-recognition treatment. (See 26 United States Code § 1031(a)(2)(D).)

In addition, the Internal Revenue Code lists other property interests not qualifying for non-recognition treatment, including a security interest in real property (such as the interest of a mortgagee or beneficiary under a deed of trust); the interest of a beneficiary under a trust having real property as its res (or asset); and mere rights, claims or causes of action involving real property. (See, generally, 26 United States Code § 1031(a)(2).)

Generally, an exchange involving relinquished real property located in the United States and replacement real property located outside the United States will not qualify for non-recognition treatment. (See 26 United States Code § 1031(h).)

"…property of like kind which is to be held either for productive use in a trade or business or for investment."

The key words here are "like kind."

This is an example of a “like kind” exchange – industrial real estate for retail real estate. Essentially “income producing real estate” exchanged for “income producing real estate”.

A restaurant can be exchanged for a motel. An office building can be exchanged for a lease of real property having a term of 30 years or more. Improved real property can be exchanged for vacant land. A single real property can be exchanged for multiple replacement properties, and vice versa.

Any exchange or part of an exchange classified as “non-like kind” is considered to be an outright sale or boot (defined in glossary) and subject to be taxed accordingly. See examples provided below.

This is an example of a “not like kind” exchange - industrial real estate for stock or bonds. Essentially “income producing real estate” for “non-income producing stocks”.

What are the financial requirements?

For your exchange to be fully tax deferred, your replacement property must be equal to or greater in value and equity than your relinquished property. The debt on your replacement property must also be equal to or greater than the debt on your relinquished property, unless cash is added to offset debt.

In some situations, a client may decide to perform a partial § 1031 Tax Deferred Exchange. This is recognized by the IRS. In this situation, a client might possibly receive some cash out from the closing of their relinquished property. This cash would be considered boot (defined in glossary) and the client would exchange the balance of the funds to complete their partial exchange.

Examples of Exchanges - with and without Boot

Let us look at four examples of exchanges and determine if there is any boot in the transaction:

1) Exchanging for equal value and equal equity –

<u>No Boot</u>

Relinquished Prop.		**Replacement Prop.**	
Value:	$3,000,000	Value:	$3,000,000
Loan:	$1,000,000	Loan:	$1,000,000
Equity:	$2,000,000	Equity:	$2,000,000

Relinquished Prop.		**Replacement Prop.**	
Value:	$1,000,000	Value:	$1,000,000
Loan:	$ 500,000	Loan:	$ 500,000
Equity:	$ 500,000	Equity:	$ 500,000

In this transaction, there is no boot to the client because the client has used all of their equity from their relinquished property as down payment on their replacement property and the debt on the replacement property is equal to the debt on the relinquished property. This should qualify this client for a full tax-deferral in regards to this transaction.

2) Exchanging up in value, but equal equity –

<u>No Boot</u>

Relinquished Prop.		**Replacement Prop.**	
Value:	$3,000,000	Value:	$4,000,000
Loan:	$1,000,000	Loan:	$2,000,000
Equity:	$2,000,000	Equity:	$2,000,000

In this transaction, there is no boot to the client because the client has used all of their equity from their relinquished property as down payment on their replacement property and the debt on the replacement property is greater than the debt on the relinquished property. This should also qualify this client for a full tax-deferral in regards to this transaction.

3) Exchanging for equal value but reduced equity –

Cash Boot

Relinquished Prop.		Replacement Prop.	
Value:	$3,000,000	Value:	$3,000,000
Loan:	$1,000,000	Loan:	$1,500,000
Equity:	$2,000,000	Equity:	$1,500,000

In this transaction, there is boot to the client in the form of Cash Boot because the client did not use all of the equity realized from the sale of the relinquished property as down payment on the replacement property. The client will realize a gain of $500,000. This gain will be taxed at the capital gains rate applicable to this transaction. This could be an example of a partial tax-deferral.

4) Exchanging for reduced value but equal equity –

Mortgage Boot

Relinquished Prop.		Replacement Prop.	
Value:	$3,000,000	Value:	$2,000,000
Loan:	$1,000,000	Loan:	$0
Equity:	$2,000,000	Equity:	$2,000,000

In this transaction, there is boot to the client in the form of Mortgage Boot because the client follow the rule which states that the debt on your replacement property must also be equal to or greater than the debt on your relinquished property, unless cash is added to offset debt. In this example, the client only used their equity to purchase replacement property. This client will realize a capital gain upon their relief of debt, which is $1,000,000. This could be an example of a partial tax-deferral.

Cash-Out Rules

1. Written agreement

2. Strict control of money or property within 180-day exchange period, except:

   - If no identification within identification period;
   - After acquisition of all replacement property; or
   - Occurrence after identification period of contingency that relates to the exchange, is provided for in writing, and is beyond control of the taxpayer and any "disqualified person".

Leaving no stone unturned, the Regulations spell out when and how the taxpayer (and others) may receive cash or other property from the exchange escrow account.

The Regulations require that provisions for cashing out of an exchange be formalized by written agreement (typically the exchange, escrow or trust agreement), which provides for strict control of money or other property within the 180-day exchange period, except:

1. If no identification is made within the identification period, then the taxpayer can cash out. This is, of course, logical, because then the exchange is disqualified anyway;

2. After acquisition of all replacement property; or

3. Upon the occurrence after the identification period of a contingency that relates to the exchange, is provided for in writing, and is beyond control of the taxpayer and any "disqualified person." Such a contingency might be unforeseen contamination of the property, inability to obtain needed parking, inability to obtain zoning changes, and the like. In such a case, the taxpayer may be legally entitled to cancel his agreement to purchase replacement property, which then spoils the exchange since his time for making another identification has expired.

Qualified Intermediaries

The IRS safe harbor rulings provides for qualified intermediaries. The regulations require that the intermediary may not be the taxpayer or a "disqualified person." The contractual relationship between the taxpayer and intermediary must be formalized by a written "exchange agreement," which must provide for the strict control of money or other property during the exchange.

Also, and very importantly, the exchange agreement may be entered into after the taxpayer agrees to transfer relinquished property. Practically, this is accomplished by the taxpayer giving the intermediary an assignment of the taxpayer's rights under the agreement to sell the relinquished property, and by giving the prospective buyer notice of the assignment.

This latter provision is of great benefit to the taxpayer. Frequently a taxpayer will have found a buyer for his property, and will have entered into an agreement for sale, before considering the tax ramifications. Worse yet, the taxpayer or listing broker may be holding earnest money, paid by the prospective buyer.

By allowing the taxpayer to enter into the exchange agreement after the agreement for sale of the relinquished property, the Regulations permit the taxpayer to convert his transaction to an exchange at any time before close of escrow on the relinquished property. And, intermediary service providers are typically able to provide the necessary forms, converting the transaction to an exchange, on very short notice.

Taxpayers should be cautioned, however, to be careful about holding earnest money after entering into an exchange. Once the transaction is converted to an exchange, all earnest money should be paid into the exchange escrow account --else the earnest money may be considered taxable.

A Qualified Intermediary is necessary to create the exchange of properties required under Section 1031. The Qualified Intermediary (Q.I.) simplifies the exchange process by accepting a transfer of your property, conveying it to a buyer, taking custody of the proceeds, buying the replacement property, and transferring title to you. It is a sensitive role requiring experience, special knowledge, and extreme care to preserve the tax deferred character of the transaction.

1. <u>Knowledge and Experience</u>

One of the first things you should look for in a Q.I. is how much knowledge they have on the subject of §1031 Exchanges and how much experience they have in the field. Asking questions of your Q.I. will help you to discover whether or not your Q.I. will be able to help you through your transaction.

One question you should ask of your Q.I. is if they are a member of the Federation of Exchange Accommodators (FEA). This is the national governing body for the Q.I. industry. Although membership is optional, being a member of the FEA shows that your Q.I. is dedicated to their industry and, in turn, dedicated to their clients. To see if your Q.I. is a member of the Federation of Exchange Accommodators, go to the FEA website at www.1031.org.

To increase the professionalism of the exchange industry and foster public confidence when selecting an exchange accommodator, the FEA administers a Certification and Continuing Education Program. The Program bestows the designation of Certified Exchange Specialist® (CES®) upon those professional individuals who meet specific work-experience criteria and pass an exam on exchange laws and procedures.

The test covers an array of exchange-related topics designed to challenge the candidate's knowledge of exchange rules and competency in performing the critical activities of an exchange facilitator company. The test also focuses on those ethical issues that emerge when any third party controls the funds of another.

A Certified Exchange Specialist® (CES®) designation demonstrates to a property owner considering an exchange that the professional they have chosen possesses a certain level of experience and knowledge. Just as when one selects an accountant or REALTOR®, it's important to review the credentials of any professional advisor prior to beginning a business relationship.

To find out if an individual is a CES® designee, go to the CES® website at www.1031ces.org.

2. "Qualified" per regulations – Nevada's Requirements

There are certain persons who may not act as your Q.I. Generally, these include certain relatives, or someone who, within a two-year period prior to your exchange, has acted as your attorney, accountant, real estate broker, or agent.

The state of Nevada is currently the only state that requires any licensing/registration of a Qualified Intermediary. This registration includes a $1,000,000 Fidelity Bond, a $250,000 Errors & Omissions Policy and an FBI background check of the Q.I. On July 1st, 2007, Senate Bill 476 became law which increased the bonding requirements on a Q.I. and allow for auditing of a Q.I. by the state, among other items.

Licensing requirements have also been established which will be monitored by the Division of Financial Institutions. To be licensed as a Q.I. in the state of Nevada, an individual must meet one of the following criteria:

A. An attorney or certified public accountant admitted to practice in any state or territory of the United States;

B. A Certified Exchange Specialist, certified by Federation of Exchange Accommodators; or

C. Person who has been actively conducting the business of an exchange facilitator or who has equivalent experience, as determined by the Division, for the 3 years immediately preceding his designation as an exchange facilitator.

Senate Bill 476 also requires the use of Qualified Escrow or Qualified Trust accounts. This also requires that the Exchangor sign off on all transfers of funds out of the exchange account. Such transfers must also be approved by the Qualified Intermediary and the Escrow or Trust holder.

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3. Security (Capital, Bond, E&O insurance) for Safety

Since the Qualified Intermediary industry is an unregulated one, where and how a Q.I. invests funds while on deposit can vary from one company to another. Therefore, an investor should investigate the following security items when searching for a Qualified Intermediary to hold their funds:

A. What kind of capital is backing up my funds?

B. What type / how much insurance (bonding) does the Q.I. hold against employee theft or error? How can I verify the bonding?

C. Is this Q.I. a subsidiary of a larger company? If so, which?

D. Where does this Q.I. place funds on deposit?

E. What type of investments does this Q.I. make with funds on deposit?

F. Does the Q.I. have any independent auditing of their exchange accounts to ensure security?

G. Are funds readily available when needed for a closing on a replacement property, or, because of the Q.I.'s investments strategy, are funds only available at certain times?

An Exchangor has every right to ask the questions above and get verifiable answers to these questions. An Accommodator who has your best interests in mind in protecting your funds will be able and willing to answer these questions.

An Exchangor must consider all of the above points in the selection of a Qualified Intermediary.

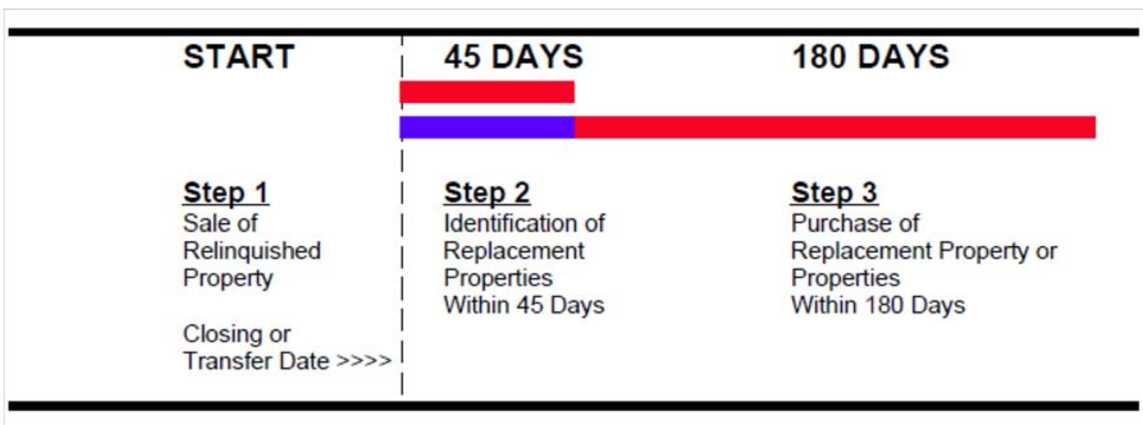
If not, they may be putting their money and their financial future at risk.

§ 1031 Exchange Time Frames

The time frames for an exchange are as follows:

- 45 days from the transfer of the relinquished property to identify the replacement property, and

- 180 days from the transfer of the relinquished property to acquire your replacement property.



The 45 Day Rule

Identification Period

- Midnight - 45th day
- Identify replacement property or properties
- Written document
- Signed by taxpayer
- Delivered or sent
- To any person involved other than taxpayer or "disqualified person"

The taxpayer must identify replacement property or properties on or before midnight of the 45th day after transfer of relinquished property. Unlike other legal deadlines with which we may be familiar, **<u>this one is absolutely firm.</u>** In the event that the 45th day falls on a Sunday or legal holiday, there is no allowance for extension of the deadline to the next business day. **<u>In fact, there is no allowance for extension of the deadline, at all</u>**.

The taxpayer's identification of replacement property must be evidenced by a written document, signed by the taxpayer, to be hand delivered, mailed, telecopied, or otherwise sent to any person involved in the exchange *other than* the taxpayer or a "disqualified person."

The term "disqualified person" is defined in the Regulations four different ways, becoming very convoluted and far-reaching. The definitions of "disqualified person" are as follows:

1. Any "agent of the taxpayer," meaning any employee, attorney, accountant, investment banker or broker, real estate agent or broker, who within 2 years of transfer of relinquished property has had such a relationship with the taxpayer. This effectively rules out almost anyone from whom the taxpayer regularly obtains legal, financial or business advice. Under this definition, there are two narrow exceptions (those who may meet the criteria but nevertheless will not be considered "disqualified"):

   A. Those performing exchange related services, and

   B. Companies performing routine financial, title insurance, escrow, or trust services.

2. Any person or business entity which is a "related taxpayer," as defined by Internal Revenue Code § 267(b). This definition includes a family member or blood relation of the taxpayer, a corporation having the taxpayer as a 10% or greater minority shareholder, a sister corporation of the taxpayer, a fiduciary of a trust having the taxpayer as its grantor, or a grantor or beneficiary of a trust having the taxpayer as its fiduciary, among others.

3. Any person or business entity having a partner relationship with the taxpayer as described by Internal Revenue Code §707(b). This includes a partnership having the taxpayer as a 10% or greater interest-owning partner, any partner having a 10% or greater interest in the taxpayer partnership, or a partnership having a common 10% or greater ownership with the taxpayer partnership, among others.

4. Any person or business entity having a disqualifying "related taxpayer" (#2 above) or partner (#3 above) relationship with a person who in turn has a disqualifying "agent of the taxpayer" (#1 above) relationship.

   This definition is hard to decipher. Our interpretation can be explained with the following example: Suppose the taxpayer proposes to send his identification notice to his family attorney. The attorney is familiar with the Regulations and tells the taxpayer that he, the attorney, is a disqualified person. Suppose further that the attorney hasn't read the definition of "disqualified person" fully, or perhaps misunderstood it, and he (the attorney) suggests that the taxpayer send his identification notice to Melvin, the attorney's adult son, who will also act as an escrow holder in connection with the exchange. Melvin, of course, has a disqualifying blood relationship with the attorney, who in turn has a disqualifying agency relationship with the taxpayer. It is this sort of "second-tier" disqualifying relationship we believe the last definition of "disqualified person" intends to address and prohibit.

Why is this so complicated? The IRS's purpose is to encourage involvement of intermediary, financial, title insurance, escrow and trust service companies in delayed exchange transactions.

This is with the expectation that such companies are less likely to have close relationships with taxpayers, and would therefore be less likely to cooperate with those taxpayers who might seek to falsify documentation in their files, such as by changing contents or falsely dating an identification notice.

By making special exception for these companies in the definitions of "disqualified person," the IRS gives the taxpayer a clear and simple choice in line with its preferences.

IDENTIFICATION OF REPLACEMENT PROPERTY

Must be unambiguous.
Taxpayer must receive substantially the same property as identified.

The Regulations make clear that the identification notice must be unambiguous in describing replacement property, and the taxpayer must acquire "substantially the same property" as identified. Although the Regulations indicate that a street address or name of building may be sufficient, taxpayers are cautioned that street addresses are assigned mainly to facilitate delivery of mail, and they may be misunderstood to include more (or less) property than the taxpayer intends to acquire. For example, a street address may, or may not, include adjacent structures, parking areas or driveways.

The better practice is to identify replacement property by reference to its complete legal description, which may be obtained from the current owner's (or lessor's) vesting deed.

Recognizing that 45 days may not be sufficient time for the taxpayer to perform due diligence or satisfy contingency items, the Regulations permit the taxpayer to identify multiple properties. In other words, the taxpayer may identify more properties than he will acquire, allowing additional time (180 days or due date of tax return, whichever is earlier) in which to make final decisions.

Identification Rules

Here are the alternative and multiple property identification rules:

- Up to 3 properties no matters what value,
- Any number of properties having aggregate value not more than 200% of relinquished property value, or
- Any number of properties provided taxpayer acquires replacement properties having value equal to at least 95% of aggregate value of all identified replacement properties.

Because of its relative simplicity, most taxpayers follow the first rule above, which the Regulations call the "3-property rule."

As can be seen, the other two rules (the "200-percent rule" and the "95-percent rule") rely on property values. Following these rules may require the additional expense of obtaining appraisals.

Once an identification notice is sent, what if the taxpayer wants to cancel it and send another?

Revocation of Identification

- Written document
- Signed by taxpayer
- Delivered or sent
- Same recipient(s)
- Midnight - 45th day

The Regulations allow revocation of an identification notice by a written document, signed by the taxpayer, delivered or sent to the same recipients as the original identification notice, on or before midnight of the 45th day after transfer of relinquished property.

It's important to remember that a revocation does not extend the 45-day identification period. The taxpayer who revokes must be careful to send another identification notice within the original 45-day identification period.

It's also important to know that, according to the Regulations, no identification is required at all if the exchange is completed, by the taxpayer's acquisition of all replacement property, within the 45-day identification period.

The 180 Day Rule

Taxpayer must acquire replacement property(ies) on or before midnight of:

- 180th day after date of transfer of relinquished property, or
- Due date (including extension) of taxpayer's tax return, whichever is earlier.

Following the 1984 amendment of § 1031, the Regulations required that the taxpayer complete the exchange, by acquisition of each and every replacement property, on or before midnight of the 180th day after date of transfer of relinquished property or the due date (including any extension) of the taxpayer's tax return (for the tax year in which relinquished property was transferred), whichever is earlier.

Once again, this deadline is firm, drop-dead, and absolute. And one should never make the mistake of thinking 180 days means six months. Exchanges have been blown, disqualified, because the taxpayer thought he had six months, which turned out to be 182 days.

Since these dates are so important, it may be worthwhile to consider the question of when relinquished property has been "transferred." Does the transfer occur when escrow closes (or the settlement date), when the deed is accepted for recording by the local county recorder, or when the deed is properly indexed by the recorder so as to be locatable in the public records?

Since the Regulations provide no clear answer, it seems best to assume that the transfer will be deemed to have taken place upon close of escrow, or the settlement date, for the relinquished property. Typically, a settlement statement (sometimes called the "HUD-1" form) will be issued showing the settlement date. This is the date to keep your eye on; begin counting the next day.

The taxpayer who transfers relinquished property late in the year, October through December, needs to be particularly careful about expiration of the exchange period. For example, if the transfer takes place in mid-December, the exchange period may expire in about 4 months, when the taxpayer's tax return is due on April 15. If the taxpayer files for an extension, the tax return will be due in August but the exchange period will then expire in accordance with the 180 day rule, since 180 days will be earlier than the taxpayer's extended filing date.

Again, although there is no regulation on point the IRS seems to accept the view that replacement property is "acquired" by the taxpayer on the settlement date.

Can Seller Carryback Notes be included in a § 1031 Exchange?

When a Exchangor (seller) of a piece of property elects to carryback a note for their buyer through their sale, the Exchangor has two options on how to treat the note:

1. Do not include the note in the § 1031 Exchange. The Exchangor would be listed as the Beneficiary on the note at the closing of the transaction and would pay taxes on the note as described under the Installment Sale provisions under Section 453 of the tax code, or 2) Include the note in the § 1031 Exchange. At the closing of the transaction, First American Exchange Company would be listed as the Beneficiary on the note. Under this method, the client has numerous choices in how they can relieve themselves of the note through the § 1031 Exchange Process, and still defer their capital gain liability.

    a. The Exchangor could use the note as down payment on their replacement property. To do this, the Exchangor must find a seller who is willing to take the note as consideration towards their purchase price. The note would be assigned from First American Exchange Company to the seller at closing.

b. The note may be paid off by the buyer before the Exchangor purchases replacement property. This option only works when the note is due to be repaid in less than 180 days. In this case, the buyer pays off the note directly to First American Exchange Company, the holder of the note. First American Exchange Company receives these funds and deposits them into the Exchangor's account, giving the Exchangor cash to purchase their replacement property.

c. The Exchangor may purchase the note from the exchange. In this case, to avoid any constructive receipt issues, the Exchangor can deposit cash with the settlement agent in the transaction equal to the amount of the note. First American Exchange Company will then assign the note to the Exchangor once the replacement property has closed.

d. The Exchangor may sell the note on the secondary market. If the Exchangor can find an individual who is willing to purchase the note from First American Exchange Company, the funds are then deposited from the buyer of the note into the Exchangor's account. Normally, an investor who will purchase the note will purchase the note only at a discount, sometimes 20% - 30% below the note's value. If such a discount occurs, some tax professionals will classify the discount as a selling expense.

If an Exchangor chooses the second option and is not able to relieve themselves of the note through the Exchange, the note is assigned from First American Exchange Company to the Exchangor upon the expiration of the 180 day Exchange Period and the Exchangor will pay taxes on the note as described under the Installment Sale provisions under Section 453 of the tax code. This is the most common way to handle a note as the Exchangor has numerous options.

What is a Reverse Exchange?

A reverse exchange occurs when an investor wants to acquire replacement property prior to the closing of the relinquished property. Although common terminology calls this type of transaction a "reverse exchange," the investor (also referred to as the "Exchangor") does not actually acquire the replacement property first and dispose of the relinquished property later. Instead, the Exchangor arranges for an Exchange Accommodation Titleholder (or "EAT") to take title to either the relinquished property or the replacement property.

This allows the Exchangor to comply technically with the "relinquish first, replace later" order, while satisfying a market requirement to close on the replacement property.

First American Exchange assists you with the entire transaction by setting up a separate entity as the EAT, as well as acting as the qualified intermediary. With the strength, security and reputation of First American Exchange, you can be assured that your reverse exchange will be handled with the utmost competence and efficiency.

First American Exchange is a Qualified Intermediary and is precluded from giving tax or legal advice. You must consult with your tax or legal advisor about your specific circumstances.

How Does a Reverse Exchange Work?

In a reverse exchange, the EAT acquires title to either the replacement property ("exchange last transaction") or the relinquished property ("exchange first transaction"). It is important to note that a reverse exchange must be set up and structured with an EAT prior to the replacement property closing.

Exchange Last Transaction

In an exchange last transaction, the EAT acquires title to the replacement property at the scheduled closing. The acquisition is funded by the Exchangor or by a loan arranged by the Exchangor.

The EAT leases the replacement property to the Exchangor, and the lease provides that the Exchangor receives all of the income and pays all of the expenses of the replacement property.

Once a third party buyer is found for the relinquished property, the relinquished property is transferred to the buyer.

After the relinquished property has been transferred to the buyer, the replacement property and any net sale proceeds from the relinquished property are transferred to the Exchangor to complete the reverse exchange.

Exchange First Transaction

In an exchange first transaction, the EAT acquires title to the relinquished property prior to the scheduled closing of the replacement property.

The EAT leases the relinquished property to the Exchangor, and the lease provides that the Exchangor receives all of the income and pays all of the expenses of the relinquished property.

On the scheduled closing date, the Exchangor takes title to the replacement property. Once a third party buyer is found for the relinquished property, the relinquished property is transferred to the buyer and any net sale proceeds from the relinquished property are used to retire any debt, or portion thereof, incurred by the EAT on its acquisition of the relinquished property.

General Requirements

Reverse exchanges under the IRS safe harbor rules must be completed within 180 days. In an exchange last transaction, the Exchangor has 45 days from the first closing to identify the relinquished property.

Most rules that apply to § 1031 Tax Deferred Exchanges also apply to reverse exchanges. All of these transactions must be set up as an exchange, rather than as a sale followed by a purchase.

How Does an Improvement Exchange Work?

An improvement exchange occurs when the Exchangor wants to acquire replacement property and build improvements on it during the exchange period. This usually occurs when the Exchangor determines that he will have exchange funds in excess of the cost of the replacement property. The excess equity is used to construct improvements on the replacement property.

In an improvement exchange, the EAT holds title to the replacement property, but the construction may be managed by the Exchangor.

The Exchangor must identify what will be constructed on the replacement property within 45 days after the relinquished property is transferred to the buyer.

The exchange must be completed within 180 days, but the construction does not need to be completed during that time. Nevertheless, the only property that is considered "like-kind" for exchange purposes will be property that is considered to be real property, i.e., attached to the land or building.

Questions, Answers, and Best Guesses

Q: *We want to do an exchange, but we don't want to use all of the sale proceeds from our relinquished property. Can we proceed using only half the proceeds?*

A: Yes. As part of the exchange agreement, you will be asked to execute an assignment of your rights as to a 50% interest in the sale proceeds from the relinquished property. The intermediary can take it from there. Please remember that any funds that you do not exchange will be taxable. Consult your tax advisor for specifics.

Q: *I want to do a § 1031 exchange including property which has been used as my personal residence as recently as 6 months ago. Is there any problem?*

A: Yes, perhaps. Obviously, you know your personal residence does not qualify for non-recognition treatment under § 1031. There is no written regulation on this, but we know that the IRS is interested whenever a taxpayer changes the use or financing of real property shortly before, or after, a § 1031 exchange. You need a tax advisor, and most would probably suggest that the property be used as income or investment property for a significant period before becoming part of a § 1031 exchange.

Q: *I want to exchange investment property for a personal residence which I would live in. How can I qualify the transaction for non-recognition treatment under § 1031?*

A: This is similar to the problem discussed above. You need a tax advisor, and most would suggest that your replacement property be used as income or investment property for a significant period after completion of your exchange.

Q&A, Continued

Q: *I am a limited partner in a limited partnership whose sole asset is an apartment building. I know that my interest in the partnership will not qualify for non-recognition treatment under § 1031. Is there any way I can structure the transaction to use this asset of mine as part of a § 1031 exchange?*

> **A:** Your tax advisor will recommend that you seek agreement from the limited partnership for a conversion of your 10% partnership interest into an undivided 10% interest in the fee title to the apartment building. If this can be done and you can meet any holding period issues described above, your 10% undivided interest in the real property may be used as part of a § 1031 exchange.

Q: *I entered into an agreement for sale of my investment property three weeks ago. Yesterday, it occurred to me that my capital gain on this sale will be substantial. Is it too late to get into a § 1031 exchange?*

> **A:** No, not until you close escrow on sale of the relinquished property. Remember that under the "safe harbor" rule for qualified intermediaries, there is express provision for entering an exchange agreement after you have agreed to sell relinquished property. You need to choose an intermediary as soon as possible (but don't be hasty - - remember how important selection of the intermediary is), and make sure any earnest money collected in connection with sale of the relinquished property is deposited in the exchange escrow account promptly.

Q: *If I own a property in one state, can I exchange it for property in another state?*

> **A:** Yes. Most title companies including our recommendation of **First American Exchange Company** handle exchanges in all 50 states, consistent with Federal guidelines.

Q&A, Continued

Q: *How long must I hold property before I can make an exchange?*

A: There is no absolute set rule, however, intent and motivation are very important. Contact your CPA for advice on this matter.

Q: *What happens if I change my mind about buying a replacement property and want to cancel my exchange?*

A: If you transfer the relinquished property and do not replace it with another, the sale will create a taxable event and any capital gain will be subject to federal and state capital gains taxes. Additionally, if you decide to cancel your exchange after First American Exchange receives the exchange proceeds, certain restrictions apply to all Qualified Intermediaries that limit access to those proceeds until certain time periods have elapsed. Our exchange professionals are available to discuss those restrictions.

Q: *What is “boot”?*

A: "Boot" can be cash received from the sale of the relinquished property or other non-cash consideration, including any property that is not "like-kind," promissory notes, or debt relief (mortgage boot). If you receive boot in an exchange, it is likely that all or some portion of the boot will be taxed.

Glossary of Terms

§ 1031 Exchange: Section 1031 is the section of the tax code that governs tax treatment of certain types of investment real estate transactions. There are several types of § 1031 exchange methods commonly used today, including delayed, simultaneous, and reverse exchanges.

Accommodator: A Qualified Intermediary who enters into a contract to assist the exchanger to effect a tax deferred exchange. The Qualified Intermediary (also known as an Accommodator) substitutes in place of the Exchanger and assumes the responsibility of transferring the Relinquished Property to a buyer and completes the exchange by purchasing the Replacement Property from a seller before transferring the Replacement Property to the Exchanger. The Intermediary maintains the exchange trust accounts to be sure that the funds are beyond the constructive receipt of the exchanger. Also described as a Facilitator or an Intermediary, an Accommodator cannot be the taxpayer or a related party.

Accommodating Party: In an exchange of properties there is always a person or entity that steps in to accommodate or facilitate the exchange transaction. This is necessary even in a simultaneous exchange without an exchange company involved. Occasionally, the seller of the replacement property or the buyer of the Relinquished Property will agree to act as an accommodating party to complete the exchange. Depending on how the transaction is structured, the accommodating party may incur additional liability in their efforts to assist in the exchange.

Adjusted Basis: The adjusted basis is equal to the purchase price plus capital improvements less depreciation. Transactions involving exchanges, gifts, probates, and receiving property from a trust can have an impact on calculating the property's adjusted basis.

Boot: Boot is any type of property received in an exchange that is not like kind, such as cash, mortgage notes, a boat or a can of anchovies. The Exchanger pays taxes on the boot to the extent of recognized gain.

Capital Gain: Generally speaking, this is the difference between the sales price of the relinquished property less selling expenses and the adjusted basis of the property.

Glossary of Terms, Continued

Constructive Receipt: The critical question in a delayed exchange is whether the Exchanger has control over the proceeds during the exchange period. Any type of account to maintain exchange proceeds must substantially limit and restrict the Exchanger's control to avoid having the exchange disallowed.

Delayed Exchange: Also called non-simultaneous, Starker or deferred, a delayed exchange is when the Replacement Property is received after the transfer of the Relinquished Property. All potential Replacement Properties must be identified within 45 days from the transfer of the Relinquished Property and the Exchanger must receive all Replacement Properties within 180 days or the due date of the Exchanger's tax return, whichever occurs first.

Direct Deeding: At the direction of the Accommodator, title passes directly to the ultimate owners without the Accommodator being in the chain of title.

Identification Period: Within forty-five days from the close of the Relinquished Property the Replacement Property must be identified by one of the three adopted rules:

1. Up to three properties of any value;
2. If over three properties, the aggregate fair market value of the replacement property can only be 200 percent of the fair market value of the relinquished property; or
3. If the aggregate fair market value of the replacement property is over 200 percent, 95 percent of the identified property must be acquired.

Improvement Exchange: Also called a build to suit exchange. In this type of exchange transaction the replacement property needs capital improvements before the exchanger takes title. To avoid the receipt of Boot, the Facilitator will take title to the Replacement Property during the construction phase. The property is transferred to the Exchanger when the improvements are complete. If all of the funds are used at the end of the 180 day period the property can be transferred and the exchange will be valid. This is true even if the improvements are not completed.

Glossary of Terms, Continued

Like Kind Property: Refers to the nature of the property the Exchanger gives up or receives in the exchange, such as real property for real property. It does not have to be similar in use such as raw land for raw land. The land could be exchanged for any other real property that will be used in a trade or business or held for investment.

Passive Activities: Any activity that involves the conduct of any trade or business in which the taxpayer does not materially participate. Losses from passive activities generally are deductible only to the extent of passive income.

Realized Gain: Refers to gain that is not necessarily taxed. In a successful exchange the gain is realized but not recognized and therefore not taxed.

Recognized Gain: Refers to the amount of gain which is subject to tax when property is disposed of at a gain or profit in a taxable transfer.

Relinquished / Replacement Property: The property given up / acquired by the exchanger in the § 1031 exchange transaction.

Reverse Exchange: An exchange where the Exchanger acquires or gains control of the Replacement Property before disposing of the Relinquished Property.

Simultaneous Exchange: Also referred to as a concurrent exchange when the Exchanger transfers out of the Relinquished Property and receives the Replacement Property at the same time.

Editor's Note: James T Saint, Real Estate Advocate™ of Halo Realty & Investments Corporation is a CCIM, (Certified Commercial Investment Member). One of a network of 9,000 professionals across North America and 30 international countries holding one of the most coveted and respected designations in the industry, and one often referred to as the "Ph.D of commercial real estate". Mr. Saint specializes in large industrial and office properties for lease or acquisition, as well as tenant or corporate advisory services for improvement of the corporate bottom line. He may be contacted at Tel: (702) 838 - 4226, or by using our web mail form at: www.halorealty.com/contactus.htm.