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# 1031 Exchange Highlights



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# 1031 Exchange

## Defined

Section 1031 of the IRS tax code allows investors to **sell investment property** and **use all of the proceeds to purchase** new investment property while deferring taxes associated with the sale.

To qualify as an exchange, the Relinquished and Replacement Properties must be qualified “like-kind” properties and the transaction must be properly structured as an exchange.

“Like-kind” Relinquished Property and Replacement Properties must be real property that has been and will be held for productive use in the investor’s trade or business or for investment.

## Reasons to Exchange

There are many advantages to structuring your transaction as a 1031 Exchange.

- ✓ Defer taxes (up to 35-40% of the gain)
- ✓ Switch property types
- ✓ Greater purchasing power
- ✓ Diversify or consolidate a real estate portfolio
- ✓ Build & preserve wealth
- ✓ Improve cash flow
- ✓ Greater appreciation potential
- ✓ Estate planning for heirs
- ✓ Expand into other real estate markets nationally

# The Exchange Process

The exchanger signs a contract to sell a Relinquished Property to the buyer..

1. The Qualified Intermediary (QI) and the exchanger enter into the exchange agreement to retain the QI as the Qualified Intermediary and the exchanger assigns the exchanger's rights in the sale contract to the QI.
2. At the closing of the Relinquished Property, the exchange funds are wired to the QI and the QI instructs the settlement officer to transfer the deed directly from the exchanger to the buyer.
3. The exchanger must identify possible Replacement Properties in writing within the 45- day identification period.
4. The exchanger has a maximum of 180 days in the exchange period (or until the tax filing deadline, including extensions, for the year of the sale of the Relinquished Property) to acquire all Replacement Property.
5. The exchanger signs a contract to purchase the Replacement Property with the seller and the exchanger assigns the exchanger's rights in the purchase contract to QI.
6. At the closing of the Replacement Property, the QI wires the exchange funds to complete the exchange and the QI instructs the settlement officer to transfer the deed directly from the seller to the exchanger.



# Exchange

## *Requirements*

As a general rule of thumb, to avoid paying any capital gain taxes in an exchange, the investor should always attempt to:

Purchase equal or greater in value.

Reinvest all of the equity in Replacement Property.

Obtain equal or greater debt on Replacement Property.

### **Exception**

A reduction in debt can be offset with additional cash from exchanger, but increasing debt cannot offset a reduction in exchange equity.

## **Calculating the Capital Gains Tax**

The gain, not the profit or equity, from the sale of investment property is subject to the combination of capital gain taxes and the tax on recapture of depreciation. It is possible for an investor to have little or no equity or profit upon sale and still owe capital gain taxes. Investors should consult with their tax or legal advisors prior to entering into an exchange.

# Basic Identification Questions



A taxpayer may identify new properties utilizing one of two rules. There is also an exception to the two rules. But for ease of discussion, let's say there are three identification rules. They are mutually exclusive, so a taxpayer may only use one rule at a time.

**Let's say a taxpayer sells an investment property for \$100 dollars:**

## 3 Property Rule

Identify one, two or three properties of any value and purchase one, two or all three properties. Providing the fair market value of the new property or properties is equal or greater to the sales price of the relinquished property, the taxpayer receives 100% deferral of their taxes.

If however, a taxpayer identifies more than three properties, then they move to the 200% Rule.

## 200% Rule

This applies if a taxpayer identifies more than three potential replacement properties.

So, if a taxpayer identifies four or more potential new properties, unlike the 3 Property Rule, the taxpayer must add up the total fair market values of all of the properties on their list. The sum must not exceed 200% of the sales price of the relinquished property. In our example, since the taxpayer sold for \$100, the total for all of the properties on the list must not exceed \$200.

### Additional Examples:

- (A) If a taxpayer identifies 5 properties and each property costs \$30, then they have identified \$150 of fair market value, which is less than the \$200 they were able to identify. **THIS IS A VALID IDENTIFICATION**
- (B) If a taxpayer identifies 10 properties and each property costs \$30, then they have identified \$300 of fair market value, which is greater than the \$200 they were able to identify. **THIS IS AN INVALID IDENTIFICATION**

## 95% Exception

This only applies when a taxpayer identifies more than three properties and the list is not in conformance with the 200% rule. The exception is that if a taxpayer closes on 95% of the properties on their list, regardless of the number of properties, they have a valid identification:

- In example (B) under the 200% Rule above, the taxpayer identified \$300 of property which exceeded the \$200 they could have validly identified. So to qualify for the 95% exception, they must close on 95% or greater of the \$300 the taxpayer identified.
- This means that the taxpayer must close on \$285 out of the 10 properties identified. Each property cost \$30, so to satisfy the 95% requirement, the taxpayer would need to close on all 10 properties to end up with a valid exchange.
- If the taxpayer only purchases 9 of the \$30 properties, then they would have purchased \$270 out of the \$300 identified and thus NOT purchased 95% or greater of the fair market value that was identified. **THESE TRANSACTIONS WILL INVALIDATE THE 1031 EXCHANGE.**

# 1031 Exchange Answers to Common Questions



## Qualified Intermediary

### -Is a Qualified Intermediary (AKA accommodator or QI) needed?

Yes. The IRS requires the use of an intermediary in virtually every 1031 transaction and the exchanger must enter into written agreements with the QI before the relinquished property is sold.

## Like Kind

### -Can I sell my rental house and buy a 4plex? Can I sell my vacant lot and buy a rental house?

Yes, you can buy ANY kind of business or investment real estate, anywhere in the US. You can sell the rental house and buy apartments, commercial, industrial, mini storage, bare land, agricultural, etc.

## Timing

### -Can I buy the replacement property first?

Yes, but that is called a "reverse exchange", which is more expensive and more work.

## Time Deadlines

### -Do I have to be in contract by the 45 days?

The identification form only requires that you give us the addresses to the properties you are identifying by the 45th day. However if they are sold to someone else on Day 46, you are out of luck. So it is recommended that you are in a firm contract by then.

### -Do I have to buy from the properties I've identified?

Yes. During the 45 days you can change what you've identified, but once your identification period is up, you must buy from only that list. No substitutions or changes after day 45.

### -Can I get an extension on the 45 day identification period?

No. Unless you have been affected by a federally declared disaster, the IRS doesn't have any provisions for extensions or exceptions – not even to the next business day if the deadline falls on a weekend or holiday. The best way to get more time is to start looking for your replacement property well before the closing of your sale property or to extend the closing date on your sale property.

# 1031 Exchange Answers to Common Questions



## Vesting and Title

### -Do I need to buy the replacement property in the exact same vesting as I sold?

No. It needs to be the same TAXPAYER. So you can sell the property in your revocable trust and buy it in your name because you are the same taxpayer. However you cannot sell as a partnership and buy as individuals – those are not the same taxpaying entities.

## Money

### -Do I just need to reinvest my profit?

No. To defer all your taxes, you need to replace the entire net sales price of what you sell, not just the gain. ["Net" refers to the sales price less the closing costs, such as escrow, title, and broker fees. Do NOT subtract the loan balance.]

### -Do I have to replace my existing loan amount?

Yes, you are not just reinvesting the equity, you need to buy equal or greater to the entire net sales price.

### -Do I have to get another loan?

You need to replace the VALUE of the loan. Either with another loan or with additional cash you may have.

## Moving In

### -Can I move into the property I buy?

The replacement property needs to be purchased with the intent of being a business or investment property. In 2008 the IRS issued a safe- harbor (Rev. Proc. 2008-16) that defines how to treat your replacement property for the two-year period after the exchange in order to safe- harbor your exchange. A common belief is that you can then convert it to personal use. However, any type of conversion needs to be discussed with your tax advisor first.

# 1031 Exchange Answers to Common Questions



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## Family

### -Can I rent the property to my child or other family member?

Yes, but they need to be treated like a regular tenant, including paying fair market rent for the property.

### -Can I buy the property with someone else?

Yes, but you would need to buy the property as tenants-in-common, where your share of the property should be equal or greater to what you sold. Also, do not create a partnership or multiple-member LLC to own the property. How you structure the co-ownership of property coming out of an exchange should be discussed with your tax advisor.

## Improvements

### -Can I get money back for making improvements to the property before I sold it?

What you did with the property is a separate issue from the exchange itself. If you receive some cash back at the close of escrow to "pay yourself back" that is taxable boot. However, your tax advisor may be able to create some tax deductions to offset your taxable boot.

### -Can I use money from the exchange to improve the new property after I buy it?

The day you take title to the property is the end of the exchange for that property. If you have cash left over, that is taxable boot. There is something called a build-to-suit or improvement exchange, where we, as the intermediary, take title to the property to make the improvements before you take ownership. This is also a more expensive and complicated transaction.