

# 1031 Exchange Fundamentals Simplified

Help Your Clients Understand Key 1031 Components



With low interest rates and current real estate conditions, the 1031 Exchange market is hot. The number of 1031 transactions is skyrocketing. What's the buzz and why should your client consider a 1031 Exchange for their investment property? Understanding 1031 fundamentals will help determine if a tax deferred exchange is a good strategic fit for your client and will give insight on how to maximize both your and your clients' profits.

## What is a 1031 Exchange?

Section 1031 of the IRS tax code offers real estate investors one of the last great investment opportunities to build wealth and save taxes. By completing a 1031 Exchange, an investor (taxpayer) can defer the capital gains taxes recognized on selling investment property by reinvesting those proceeds into another like-kind investment property. The regulations that govern 1031 Exchanges are very specific and must be followed to have a successful exchange.

## Why Utilize a 1031?

Through a 1031 Exchange, an investor can sell investment property and accomplish a number of valuable tax and investment goals. Depending on your client's circumstances, opportunities may include deferring taxes (up to 35 to 40% of the gain) as well as having greater purchasing power, improved cash flow, portfolio diversification, portfolio consolidation, greater appreciation potential, freedom from joint ownership, geographic relocation (due to a move or to reduce risk due to weather or environmental concerns), estate planning for heirs with a stepped up basis and more.

## Key 1031 Guidelines

The 1031 Exchange rules and regulations must be strictly followed for a successful 1031 Exchange. Here are some important highlights:

1. Any property involved in an exchange (Relinquished and Replacement) must have been held for investment or used for productive trade or business use. Primary residences and second homes do not qualify for gain deferral under the 1031 regulations. Property exchanged must be like-kind. For real property exchanges, what is "like-kind" is very broad. A taxpayer can purchase virtually any type of real property for replacement property. In other words, a taxpayer can sell a single family home and purchase an apartment building or sell farmland and purchase a condominium.
2. A taxpayer cannot receive cash proceeds (actually or constructively) or other benefits directly from the property sale. To achieve this, the services of a Qualified Intermediary (QI) needs to be utilized. The QI will work with the taxpayer's advisors and facilitate the entire process of the exchange, including preparing the exchange paperwork, coordinating with the settlement agents and safeguarding and distributing the exchange funds. The QI must be engaged before the transfer of the Relinquished Property. The QI cannot be related to the taxpayer or anyone who has acted in a financial or advisory role to the taxpayer like an attorney, CPA, or real estate professional within the last two years. This restriction does not apply if the only services were to facilitate a 1031 exchange in that two-year period.
3. There are strict timing deadlines. From the day that the Relinquished Property sale closes, the taxpayer has 45 calendar days to identify Replacement Property and 180 days to acquire the Replacement Property.
4. For a complete deferral of taxes, the taxpayer must buy equal or greater in value compared to the Relinquished Property, use all of the proceeds from the sale to acquire Replacement Property and replace the value of debt that existed on the Relinquished Property. Any debt can be replaced with new debt, seller-financing or cash from outside of the exchange.
5. Exchange requirements mandate the same taxpayer that sold the Relinquished Property acquire the Replacement Property. Title to the Replacement Property can be placed in an entity that is disregarded for federal tax purposes, such as a single member LLC.

## 1031 Process, Information Needed & Closing of Escrow

An exchange can be opened quickly online at [www.ipx1031.com](http://www.ipx1031.com) or by phone, however it is important that the taxpayer contacts the QI prior to the transfer of the Relinquished Property to set up the exchange. A 1031 Exchange cannot be opened after the property is transferred. To facilitate a smooth transaction, exchange cooperation language should be included in the purchase and sale agreements (for Relinquished and Replacement Properties). When an exchange is opened, the QI will need information including the taxpayer's personal information, the escrow or closing agent's information and Relinquished Property information. The property closing will still be handled by an escrow or closing agent and the properties are directly deeded between the buyers and sellers. The QI will handle all exchange document preparation and execution, as well as receive and hold the exchange funds and wire them when replacement property is acquired.

## IPX1031®

This overview has been simplified to touch on important factors of the 1031 Exchange and process. Like all real estate transactions, investors are urged to seek legal, tax and financial counsel prior to engaging a 1031 exchange. Investment Property Exchange Services Inc. (IPX1031®) is a Qualified Intermediary that provides a full range of tax deferred exchange services including delayed, reverse, build-to-suit, multiple asset exchanges, and personal property transactions. As the nation's largest QI, IPX1031® has offices throughout the country and a highly skilled team of exchange attorneys, Certified Exchange Specialists (CES®), CPAs, coordinators and sales executives to provide timely information. We look forward to helping you and/or your clients maximize qualifying investments through a 1031 Exchange strategy.



The following points are mentioned as a means to address issues that taxpayers frequently encounter when doing a 1031 Exchange. Please feel free to contact Investment Property Exchange Services, Inc. (IPX1031®) if you or your client have any questions. IPX1031® cannot provide tax, legal or financial advice to taxpayers.

### Pre-Planning & 1031 Consultation

- ❑ Ensure a 1031 Exchange is appropriate for the Exchanger's tax situation and investment strategy.
- ❑ Determine whether to use one Exchange or multiple Exchanges when more than one Relinquished Property (RQ) is being sold.
- ❑ Determine the target value of the Replacement Property (RP) if some portion of the RQ is used as a personal residence.
- ❑ Determine the amount of personal property, if any, that will be included in the sale of the RQ and in the purchase of the RP. This may result in a separate Personal Property Exchange.
- ❑ Determine the best structure for the Exchange (e.g. Delayed, Build-to-Suit, Reverse, etc.). Due to the complexities, there are specific rules and additional requirements for Build-to-Suit (making improvements to your RP as part of the Exchange) and Reverse (purchasing the RP prior to selling the RQ) exchanges. Reach out to IPX1031® for more information.
- ❑ Determine any vesting issues up front. The same "taxpayer" that sells the RQ must acquire the RP. Issues may include but are not limited to:
  - ⇒ Lending requirements related to acquiring the RP.
  - ⇒ Needing to add parties to title.
  - ⇒ If the Exchanger is holding title to the RQ with other individuals or entities, or holding title in a partnership, corporation, trust, LLC or similar entity, and all of the co-owners will not participate in the Exchange, there are additional important issues to consider prior to the Exchange.
- ❑ The payment of non-refundable earnest money prior to closing, withholding cash from the sale proceeds, doing any seller financing for the Buyer of the RQ or any plans to pay off debts that are not secured by the RQ should be discussed at this time.

### Important Things to Keep in Mind

- The Exchanger must initiate an Exchange with IPX1031® prior to transfer (escrow closing) of the RQ.
- The Exchanger must identify potential RP within 45 days (Identification Period) and close on any or all of identified RP within 180 days (Exchange Period). Both the Identification and Exchange Periods begin at the transfer of the RQ.
- The Exchanger must use all the cash in the exchange account for the purchase of RP or may have taxable boot.
- The Exchanger must incur debt on the RP of equal or greater than the debt paid off on the RQ or replace it with additional cash (from outside the 1031 exchange) to completely defer all taxes.
- There are restrictions on what the QI can pay for with exchange funds and when unused funds can be refunded to the Taxpayer.
- Buying the RP from a person or entity classified as a "Related Party" requires careful consideration and may not be permitted.
- The property or properties being sold must have been held by the Exchanger for use in a trade or business or for investment purposes and they must intend to hold the property or properties they are purchasing for use in their trade or business or for investment purposes, i.e. rental homes, commercial property or vacant land. 1031 Exchanges are not appropriate for second homes, flips, new construction or development projects.



## Qualified Intermediary

### Is a Qualified Intermediary (QI or Accommodator) needed?

Yes, unless you are doing a simultaneous swap with another party. If the exchange is not simultaneous or you are selling to one party and buying from another party, a QI, like IPX1031® must be engaged before the relinquished property is transferred. A QI must not be an agent of the taxpayer.



## Like Kind

**Can I sell my rental house and buy a 4plex? Can I sell my vacant lot and buy a rental house?** Yes, virtually all business or investment real estate located in the U.S. is "like-kind". You can sell the rental house and buy apartments, commercial, industrial, mini storage, bare land, agricultural, etc.



## Time Deadlines

**Do I have to be in contract by the 45 days?** No. The regulations only require that potential replacement property be unambiguously designated in a writing signed by you and delivered to a qualified person (usually the QI) by the 45th day of the exchange. However if the property or properties are sold to someone else on Day 46, you are out of luck. So it is ideal that you are in a firm contract by then and identify backups.

### 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 has expired, you must buy from only that list. No substitutions or changes are permitted by the statute 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 of your sale property or to extend the closing date on your sale property.



## Timing

**Can I buy the replacement property first?** Yes, but that is called a "reverse exchange", which is more expensive, more complicated and has its own set of rules and regulations that must be followed.



## Vesting and Title

**Do I need to buy the replacement property in the exact same vesting as I sold?** No. However, 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 have a full tax deferral, you need to do three things: buy equal or greater in value compared to the property you sold, reinvest the entire net sales proceeds from the property you sell into your new investment property AND replace the value of the loan that you had on your old investment property.

**Do I have to get another loan?** Not necessarily. You need to replace the VALUE of the loan. This can be achieved through a loan on the new investment property, additional cash from outside of your 1031 Exchange or a combination of both.



## 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 Revenue Procedure 2008-16. It provides a procedure to convert an investment property to a personal use property after a two-year period from when the 1031 Exchange is completed. However, a conversion of this type needs to be discussed with your tax advisor.



## Family

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

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

**Can I buy the property with someone else?** Yes, but you need to buy the property as tenants-in-common, where your share of the property will be equal or greater to what you sold (to have a fully tax deferred exchange). 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 your 1031 Exchange. If you receive some cash back at the close of escrow to "pay yourself back" that may be considered to be taxable boot. However, your tax advisor may be able to create some tax deductions to offset some or all of the taxable boot.

**Can I use money from the exchange to improve the new property after I buy it?** No. However there is another option called a build-to-suit or improvement exchange, where the QI, through a separate entity, takes title to the property while the improvements are made and then transfers the improved property to you. Like a reverse exchange, this is a more expensive and complicated transaction so call us today to find out if it makes sense for you.