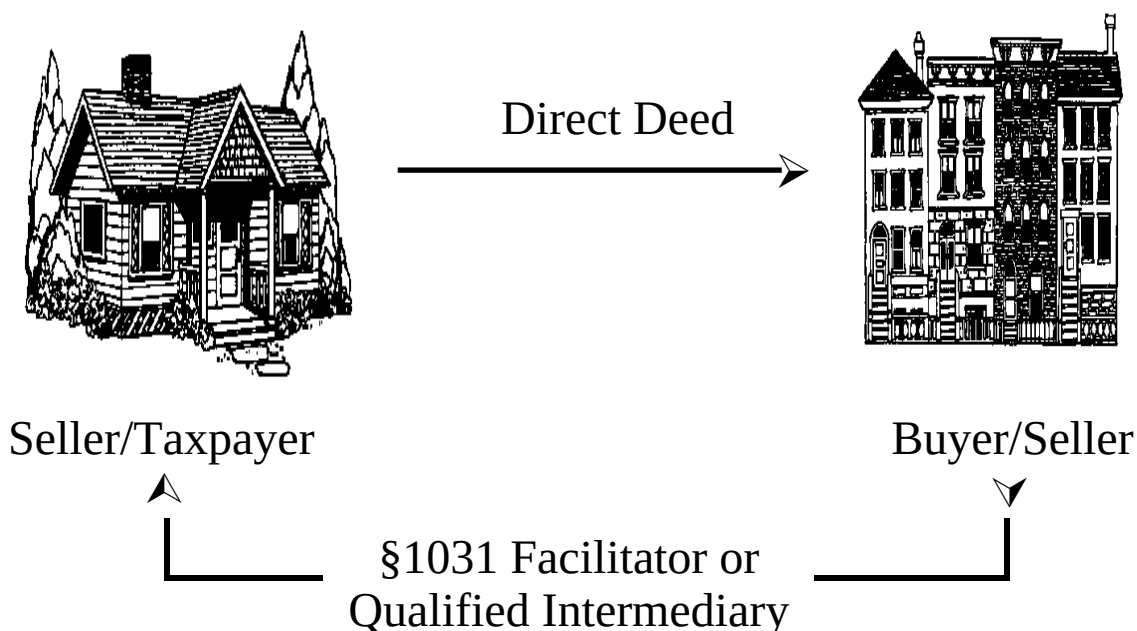


# §1031 TAX-DEFERRED EXCHANGES



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## **INTRODUCTION**

Death and taxes. You know the saying. Fortunately, it's not always true. With some basic tax planning, you can delay paying federal income tax on your next real estate deal. And, by deferring payment of those taxes, you can increase the profits on your next real estate investment. This tax deferral can be achieved through a "like-kind exchange" of property.

As the name implies, a like-kind exchange is simply a trade of similar type properties. "Like-kind" property does not mean that the properties must be identical in quantity or quality. Rather, the focus is on the character of the property. This means that the property you give up ("the relinquished property") and the property you acquire ("the replacement property") must both be held for investment or business purposes.

For example, you can trade an apartment building for undeveloped land. Or you can trade 5 acres of farmland in the country for an apartment building in the city. You can even trade long-term leasehold interests or undivided interests in property. As long as the properties are held for investment purposes, the properties meet the "like kind" test. Unfortunately, you cannot engage in a trade that involves your personal residence. For example, you cannot trade a rental house for a new home to live in.

The tax savings are no gimmick. Section 1031 of the Internal Revenue Code specifically allows such trades to be made and the taxes to be deferred. In a moment, you will learn exactly how §1031 of the Tax Code permits you to defer paying taxes you would otherwise owe to the IRS. You will also learn how to sell one piece of property now, buy another six months later, and still qualify for §1031 treatment! In fact, there is even a way to buy a piece of property now and later sell the property you now own.

A word of caution - to claim the benefits of a like-kind exchange, you must follow certain steps. And, you must avoid others at all costs. This memo outlines the steps that you must take and the ones you must avoid.

There is one important qualification - like many tax-planning devices, a like-kind exchange can be extremely complicated. Even after reading this memo, you will only have a general idea of like-kind exchanges. Do not attempt to handle such a transaction without consulting a knowledgeable, experienced attorney or tax advisor. Without such help and guidance, the results could be disastrous.

Now let's look at a basic like-kind exchange transaction.

## **THE SIMULTANEOUS EXCHANGE**

In its most basic form, a like-kind exchange is accomplished by transferring property to one person, who in turns "pays" for the property by transferring similar property to you. In short, the buyer and seller trade properties straight across. Under these circumstances, simply negotiate your best deal and have your realtor finalize the transaction. In most cases, the trade can be accomplished with relatively little complication.

As you may have guessed, such trades are rare. You will be very lucky to find a buyer who is willing to purchase your property and who also just happens to own a piece of property that you want. Most likely, you will find a buyer who wants to pay cash for your property, but the property you want to purchase is owned by someone else. In fact, you may not have even located the property you want to purchase.

Although accomplishing a like-kind exchange under these circumstances can be a bit tricky, a competent attorney or tax advisor can still do it. The trade is accomplished through a concept called a "delayed exchange."

## **THE DELAYED §1031 EXCHANGE**

The delayed exchange allows you to sell your property now and another property later. Once again, this tax-planning device is no gimmick. The tax laws specifically allow such a transaction. The steps are relatively simple.

First, after negotiating the basic terms for the sale of the property you now own - the "relinquished property" as it is called under the tax laws – review the form you are using to be certain the document includes a "§1031 exchange cooperation clause." Most standard forms already include such a clause. If not, then insert the following "cooperation clause" in your earnest money agreement or purchase and sale agreement:<sup>1</sup>

The Purchaser agrees to cooperate with the Seller in conducting a like-kind exchange of property under §1031 of the Internal Revenue Code. "Cooperation" includes, but is not limited to, the signing of any documents reasonably necessary to conduct the exchange, including Deeds, Qualified Trust Agreements and Escrow Instructions, and Property Exchange

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<sup>1</sup> For your convenience, a sample contract addendum is included at the end of these materials.

Agreements. The exchange may involve a “Starker”-type deferred or delayed exchange.

If the buyer does not understand his or her role in the like-kind exchange, explain to the buyer that his or her role will be nominal. Basically, the buyer only has to sign some additional documents as part of the real estate transaction. The buyer will not have to pay any more money to acquire your property, and the buyer will not face any risks in cooperating with you.

Second, be certain that you and the buyer choose an escrow agent or attorney who can handle delayed §1031 exchanges. Although many attorneys, title insurance companies, and escrow houses can effectively handle basic real estate closings, not all closing agents can handle them in an effective manner. Handling delayed like-kind exchanges requires experience and some expertise. Specialized escrow devices and trust agreements are required, and not every escrow agent is competent enough to understand the details of such a transaction.

Because, as a matter of tradition, the buyer selects the escrow agent or closing agent to handle the closing, you should be certain that the buyer designates an escrow company or attorney with experience in handling like-kind exchanges. A further word of caution - shop before you buy. Some escrow agents will generally charge more for this service. Ask the escrow company if there will be any additional fees because of the §1031 exchange. Be certain that the charges are not too high.

The third step is the most critical. The third step involves restructuring the sale to comply with the strict requirements of the tax laws. The documents necessary to restructure the transaction and insure that the transaction qualify for a §1031 exchange treatment are very specialized. They are not the type of documents or “fill-in-the-blank forms” that can be bought at a bookstore or online.

Most people retain a §1031 Facilitator or Qualified Intermediary to handle this step in the exchange process. It’s money well spent. A good Facilitator or Qualified Intermediary will make certain that you comply with the tax laws and help guide you through each step in the process.

The fourth step is closing the transaction with the buyer. This is the second most important step. For you to claim the tax benefits of a §1031 exchange, the funds from the sale of your property must be handled in a specific manner as outlined in the tax laws. Again, sophisticated trust and escrow arrangements are used to handle the sale proceeds.

If you have retained a good §1031 Facilitator or Qualified Intermediary, you don't have to worry. The Facilitator or Intermediary will insure that you are well protected and that you are in full compliance with all tax laws.

Fifth, locate the property you want to buy. This is the replacement property. You must identify the replacement property within 45 days from the date the sale of the relinquished property closed. To “identify” a property you can simply list its address and send a written notice to the exchange facilitator. This 45 day identification period gives you time to locate replacement property without having to delay the sale of the relinquished property.

You can even identify several different potential replacement properties. The rules for identifying more than one replacement property are very strict and sometimes complex. Exactly how you go about “identifying” the replacement property is a matter you and your §1031 Facilitator will need to review carefully.

You may negotiate the purchase of the replacement property yourself, including signing an earnest money agreement. Like with the agreement to sell your relinquished property, your agreement to purchase replacement property should include a §1031 “cooperation clause.” Most standard forms already have such a clause. If not, an experienced §1031 Facilitator or Qualified Intermediary can provide an addendum for you to use.

Sixth, close the purchase of the replacement property. The purchase must be finalized within 180 days after the sale of the relinquished property, or the due date of your tax return for the taxable year in which the relinquished property was sold, whichever is earlier. As a practical matter, since the IRS allows you to automatically extend the due date of your tax return filing, with some simple planning you can have the full 180 days to close the purchase of the replacement property. Your exchange facilitator will handle the necessary paperwork for escrow to close the purchase as a tax-deferred exchange.

Finally, you must report the exchange transaction to the IRS using appropriate reporting forms. The status of certain exchange transactions must be reported to the IRS for as long as the next three years. Your tax preparer or CPA will help you with this reporting requirement.

## **THE REVERSE §1031 EXCHANGE**

In a typical exchange, you sell your property first and buy your replacement property later. Like the name implies, in the reverse exchange, everything is backwards. A reverse exchange involves buying new property first and then later selling the property you currently own.

Until September of 2000, the reverse exchange was not specifically permitted under the tax code. Some §1031 Facilitators and Qualified Intermediaries used a variety of creative and sophisticated tax-planning devices to accomplish a reverse exchange. Other Facilitators and Qualified Intermediaries did not even handle reverse exchanges. There was simply too much risk involved.

That has now changed. The IRS now specifically allows a taxpayer to participate in a reverse exchange. The reverse exchange still involves a greater degree of complexity than does a basic exchange. And, as a general rule, it involves greater cost. But, if you happen to find a piece of property that you ‘must have’ but don’t yet have a buyer for the relinquished property, then a reverse exchange is now an option for you to consider.

The time deadlines are basically the same as in a delayed exchange. After purchasing the replacement property, you must identify which relinquished property you plan to sell. You must make this identification within 45 days of buying the replacement property. Then, you must sell your relinquished property within 180 days.

## **SOME RISKS AND DISADVANTAGES**

There are, of course, some risks and disadvantages associated with participating in a §1031 exchange. First, the escrow fees may be higher than usual. Second, you will generally need to retain a §1031 Facilitator or Qualified Intermediary to coordinate the exchange. That will cost money. Third, reporting and accounting for the transaction will cause your accountant's fee to be a bit higher. Fourth, if you use the delayed exchange, the 45-day identification period cannot be extended, so there is a risk you cannot locate suitable replacement property in time. Fifth, there is always the inherent risk that the IRS will audit your tax return and focus on your §1031 exchange. But, if you have used an experienced §1031 Facilitator or Qualified Intermediary and they structure the exchange within the IRS’ “safe harbor” rules, then the transaction will be immune from a successful IRS audit. Sixth, the trade might not be totally free from taxation. If there is any difference in the value of the properties traded, or if the trade involves dissimilar properties (*e.g.*, trading real estate in part

for personal property or money), there probably will be some income tax owed on the transaction.

One disadvantage of a §1031 exchange is that your replacement property will typically have a smaller tax basis than the purchase price, since the replacement property's tax basis is based, in large part, on the tax basis of your relinquished property. A lower tax basis typically means lower depreciation deductions.

Whether or not you should accept the risks and possible disadvantages of a §1031 exchange hinges on exactly how much net savings you will realize through the exchange. Only then can you weigh the benefits of a §1031 exchange against the costs and risks that an exchange involves. Let's look at the economics of the decision you face.

### **THE ECONOMICS OF AN EXCHANGE**

Use the following formula as a general guide to determine if you should spend the money to participate in a §1031 exchange:

Whereas,

Gain = Realized taxable gain

Rate = Your marginal tax rate

ROI = Your expected annual rate of return on investment in replacement property

H = Number of years you expect to hold the replacement property

If  $(\text{Gain} \times \text{Rate} \times \text{ROI} \times H) > \$2,500^2$ , then use a §1031 exchange

Put simply, if the additional return you make on the taxes you delay paying is more than the cost of doing a §1031 exchange, then use the §1031 exchange. You'll be dollars ahead.

For example, assume you own a parcel of land with an adjusted tax basis of \$120,000. The property is now worth \$220,000. Thus, if you sold it, you would have

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<sup>2</sup> This amount represents a reasonable estimate of the total costs, direct and indirect, of participating in a §1031 exchange. Costs generally include facilitator/intermediary fees to handle the actual §1031 exchange, additional charges for escrow, and additional charges of a CPA or other tax preparer to report the §1031 transaction on a tax return. Your actual costs may vary. Obtain reliable estimates of the *total* costs of a §1031 exchange before proceeding.

\$100,000 in capital gain or ordinary income (\$220,000 sales price - \$120,000 tax basis = \$100,000 taxable gain or income).

If the gain is long-term capital gain, and you are in a 15% capital gain tax bracket,<sup>3</sup> then you would owe \$15,000 in federal income tax on the sale.<sup>4</sup> (\$100,000 gain x 15% tax rate = \$15,000 in taxes)

Now assume that you decide to participate in a §1031 exchange instead. And, as a result of the §1031 exchange, you acquire another parcel of property worth, say, \$320,000. Your "savings" can be computed as follows: through the §1031 exchange, you have deferred \$100,000 in taxable gain and, thus \$15,000 in federal income tax. Assuming that you earn an average rate of return of 10% on your real estate investments, you will earn an extra \$1,500 each year because of the tax savings (\$15,000 x 10% = \$1,500). So, even if you keep the replacement property for just two years, you are still money ahead. If you keep the property even longer, your additional return on investment will be even larger.

Keep in mind that you do not *avoid* taxes using a §1031 exchange; payment of the taxes are only *deferred*.<sup>5</sup> Using the earlier example, if you sold the new property for \$330,000 the following year, you would have \$110,000 in taxable gain that year (assuming you claimed no depreciation deduction for the year). This is because the \$120,000 tax basis in your old property is "carried over" to the new property (\$330,000 sales price - \$120,000 carry over tax basis - \$100,000 tax basis resulting from "trading up" to higher priced property = \$110,000 taxable gain). That \$110,000 in gain would result in \$16,500 in taxes due the IRS.<sup>6</sup>

And remember, each situation is unique. Your particular tax situation may be different. Issues such as depreciation recapture, net investment income tax, and a special Medicare surtax may affect your particular tax situation. If you need a more detailed analysis, consult your accountant or tax advisor.

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<sup>3</sup> The tax rate on long-term capital gains is based on a graduated scale, and ranges from 0% to 20%.

<sup>4</sup> This example ignores any income from depreciation recapture or the impact from gain being considered net investment income, which can result in a 3.8% tax surcharge. Plus, under some tax circumstances, an additional .9% Medicare tax may be imposed. Accordingly, many taxpayers use a more conservative, 25% marginal rate to analyze the economics of a 1031 exchange under consideration. Consult your accountant, tax preparer, or tax advisor for more details.

<sup>5</sup> With proper tax and estate planning, you may actually be able to *avoid* all of the taxes. The estate and tax planning devices used to avoid taxes are far beyond the scope of this memo. Consult your attorney or tax accountant for more information.

<sup>6</sup> Again, this example is very simplistic. Taxes on that \$110,000 gain will likely be larger.

## **CONCLUSION**

In conclusion, with just a little bit of planning, you might be able to save considerable money through a like-kind exchange. Now that you have the basic concept in mind, you should be able to negotiate your next real estate deal with a §1031 exchange in mind.

If and when you decide to actually use a §1031 exchange, be sure to consult your realtor, and then your tax advisor or an experienced §1031 Facilitator before proceeding.

## **FREQUENTLY ASKED QUESTIONS ON §1031 LIKE-KIND EXCHANGES**

### **THE DEFINITION OF “LIKE-KIND”:**

**Q:** What does "like-kind" property really mean? If I sell a single-family residence, do I have to buy another single-family dwelling? I want to sell my rental house and use the money for a down payment on an 8-plex. Can I really do that?

**A:** You most certainly can. "Like-kind" refers to the general investment character of the property, not the quality or quantity. Thus, if you hold your relinquished property for investment or business purposes, then you must acquire property intended to be held for investment or business purposes.

It makes no difference if either property is raw land, a single-family rental, or a multi-plex. So, you can trade raw land for a multi-plex, a multi-plex for raw land, a single-family rental house for a 10-plex, a 10-plex for a duplex, and so forth.

Leveraging your profit from one property into another larger, more valuable piece of property is one of the most compelling reasons for participating in a §1031 exchange.

**Q:** I am selling one piece of rental property, and I want to buy two. Can I do this in a §1031 exchange? Is there any limit on the number of properties I can purchase?

**A:** You can buy the two properties. The §1031 rules and regulations contain no restriction on the number of replacement properties you can purchase. You can sell a house and buy 50 building lots if you'd like. Be careful, though. If you start buying and selling many properties on a regular basis, the IRS might classify you as being a "dealer." This means that the real estate is treated like "inventory." If the property is inventory and not "investment" property, you won't be able to participate in §1031 exchanges.

### **PURCHASE OF A HOME OR RESIDENCE:**

**Q:** Can I sell my rental house and use the sale proceeds to buy a home for myself?

**A:** No. The IRS does not consider your rental house and a personal residence to be "like-kind" property. The rental house is held for investment purposes. The home that you will live in is

for personal use. It is not considered “investment” property for §1031 exchange purposes, no matter how much you expect to gain economically by owning your own home.

**Q:** After I complete my §1031 exchange, can I ever move in to the replacement rental property and make it my home?

**A:** Yes. The §1031 rules and regulations provide that you must purchase the replacement property with the intent to “hold it” as investment property. The issue boils down to your intent on the day you purchase it. If you truly intend to hold the replacement property as investment property, but later events occur which create a circumstance that results in your need or desire to use the property as your personal residence, you will probably not lose the benefits of §1031. Under those circumstances, you can convert the rental house into your personal residence. But be wary – each circumstance is different.

For example, assume you purchase your replacement property in a §1031 deal and three months later, your home burns down. You need a place to live. You could move into the “rental” property and would almost certainly not risk losing the §1031 benefits.

Now assume that you purchase the rental property in a §1031 deal and try to rent it out for three months. You set the rental amount so high that no reasonable person would ever want to rent it. During that same time, you sell your existing home. After three months, you claim, “Well, I *tried* to rent out the place. I guess I just have to move into it now.” The IRS would probably argue that you did not really purchase the rental house with a true intent to hold it for investment purposes. You would probably lose the benefits of your §1031 exchange under these circumstances.

**Q:** Assuming that there are no special circumstances in my case, exactly how long do I have to rent out the property before I can move into it?

**A:** There is no specific time period. Again, the IRS analyzes each case separately. The longer you rent out the house, the less likely moving into it will result in the §1031 exchange being attacked by the IRS. As just a rule of thumb, renting it out for less than a full year will be suspicious. Renting it out for more than 2 years should suffice.<sup>1</sup> You are in a gray area if you move in after renting it for a full year but less than two years.

**Q:** Once I have rented out the house long enough to show that it was intended to be a “rental property” and then live in it for two years as my personal residence, I can sell the house and claim the \$250,000 tax exemption for sale of a personal residence, right?

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<sup>1</sup> See the questions below regarding vacation homes and second homes. Because there is a “safe harbor” if you hold and rent out those types of properties for 2 years, the same logic should apply to a rental property you later convert into your personal residence.

- A:** No. The IRS is tightening this loophole. In addition to the usual “2 out of 5 years” rule under §121 of the tax code, you must now own the property for the full 5 years before you can claim the exemption. So, if you rented out the house for 2 years, you would need to live there 3 more years in order to claim the exemption. (The exemption is \$500,000 for a married couple).

## **PURCHASE OF VACATION HOME OR SECOND HOME:**

- Q:** My husband and I wish to buy a property at Suncadia. We will keep our existing home and use the one in Suncadia only on weekends. We are confident it will increase in value over time, so will be a good investment property. Will the property qualify for a like-kind exchange?

- A:** No. The tax regulations do not recognize vacation homes or second homes as being “held for investment purposes.” They are treated differently than rental property. The mere expectation that the property’s market value will increase over time does not make the property qualify as investment property.<sup>2</sup> Instead, in the eyes of the IRS, the property is held primarily for personal benefit.

- Q:** So what if I rent out the house to generate some income, such as through Airbnb or VRBO?

- A:** Then it depends on how many days you rent the property and how many days you use the house personally.<sup>3</sup> The first requirement is that you must rent the house out for at least 14 days a year for the first two years of ownership. Second, tax regulations provide that you may stay in the house up to the greater of 14 days or 10% of the time it is rented. For example, if you rent the house for 200 days a year, then you can stay there for up to 20 days without risk that the property will be considered a vacation home or second home. The bottom line? If you are willing to limit the amount of time you spend at the house for the first two years, then the vacation house qualifies for §1031 treatment.

- Q:** So, if we do rent out the house for at least 14 days a year for two years, and limit our personal use during that time, after two years, we can stop renting it out and not risk losing the benefits of 1031 tax treatment?

- A:** Yes. After the first two years, you will have met the IRS’ “safe harbor” rules. You are then free to treat the house as a true vacation home or second home for as long as you wish.

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<sup>2</sup> *Moore v. Commissioner*, TC Memo 2007-134.

<sup>3</sup> See Rev. Proc. 2008-16.

## **“FLIPPING” PROPERTY / REAL ESTATE DEALERS:**

**Q:** I was told that if I did not own the property for a full year, then I cannot use a 1031 exchange. Is this correct?

**A:** No. There is no ‘time of ownership’ requirement under 1031 rules and regulations. What the person might have been referring to is the requirement that the property you are selling be “held for investment purposes.” Conversely, a 1031 exchange cannot be used for property that is “held for *resale* purposes.”

How long you owned the property is one of many factors used in determining if you held the property for *investment* purposes or for *resale* purposes. In fact, how long you owned the property is often the main factor. But, to say you can or cannot utilize §1031 of the tax code based only on how long you owned a piece of property is over simplistic.

Most cases of property held for “resale” involve a real estate dealer. Real estate dealers are taxpayers whose primary business is buying, selling, or developing real estate on a regular basis. Developers are the most common example of a “dealer.” If a person buys some land, subdivides it, then sells off the lots, that person is likely to be considered by the IRS as someone who held the land for “resale” purposes. §1031 exchanges cannot be used in those scenarios. The property is considered part of the dealer’s inventory, not a true investment property.

Similarly, a taxpayer “flipping” property might also be considered as someone who bought the property for “resale” rather than “investment.” A variety of factors would be considered in making this determination.

How long was the property owned? The longer the better. Some tax advisors recommend holding the property for a full year, plus at least 1 day. That way the property is reported as an investment property in two different tax years. While this holding period does not guarantee §1031 treatment, it is a pretty good rule-of-thumb.

How many transactions does the taxpayer engage in each year? The fewer the better. For example, a person might be buying and selling 6 houses a year and derives 90% of their income from the flips. Even if each house was owned for a year plus a day, the IRS would likely treat the person as a dealer in real estate, and therefore the real estate is inventory held for resale, not as investments.

What prompted the sale? If the taxpayer held the property for just a few weeks and had plans to rent it out, but then received an unsolicited offer to purchase, the taxpayer probably will qualify for 1031 treatment. The taxpayer might have intended to hold the property for investment purposes at the time of purchase, but the unsolicited offer could be viewed as a material change of circumstances that the taxpayer did not create or even anticipate.

## **RENTAL INCOME ALLOCATION AT CLOSING:**

**Q:** I receive rent on the property I am selling. How will the rents be handled in closing? Will the rent be considered “boot” in my §1031 exchange?

**A:** The allocation or pro-ration of rents between you and the buyer of the property can be handled "inside" escrow or "outside" of escrow. If the escrow agent handles the rent, the rent will be pro-rated based on the date of closing. The amount the buyer pays and the amount paid into the §1031 trust account will be adjusted accordingly. If the rents are handled "outside" of escrow, then it is up to you and the buyer to make the allocation and exchange any money between yourselves. You and the buyer should decide how you wish to handle the allocation of rents and instruct the escrow agent accordingly. As a general rule, the escrow agent will not handle the pro-ration of rents or the transfer of rental deposits unless you and the buyer agree, and then instruct the escrow agent to handle the matter for you.

The tax consequences are the same in either event. The IRS "disregards" any rent that you receive as a result of the sale of the property, whether it is handled "inside" or "outside" of escrow. You must report the rent as income for federal income tax purposes, but it is not considered "boot" when you sell the property.

## **TITLE PROBLEMS AND COMPLICATIONS:**

**Q:** I own some investment property through a partnership. We have decided to sell the property, but not all of my partners wish to do a §1031 with their sale proceeds. Can I still do a §1031 exchange?

**A:** Yes, but you must do some pre-§1031 planning first. The IRS does not allow you to exchange your partnership interest. The trick is to convert your "partnership interest" in the property into an interest in the real property itself, usually a "tenant in common" interest. Then do your §1031 exchange. In almost all cases, the result is exactly the same.

This device is sometime referred to as a “drop and swap.” The “drop” refers to the process of transferring title out of the entity and into the owners. The “swap” refers to the §1031 exchange process.

Hint: make certain that you truly own the property as "partners." Many times investors will purchase property jointly as "tenants in common," but end up referring to their co-owners as their "partners." A partnership is a legal relationship and just because more than one person

owns a piece of real estate does not mean that you are "partners" with those other persons or that a "partnership" owns the real estate.

**Q:** I am selling rental property than I owned prior to my marriage. I want my spouse and I to be on title to the new rental property we are buying as part of the §1031. Can I do this? If so, how?

**A:** Yes, you can eventually own the replacement property as spouses. But you have to do a bit of planning to make certain you fully comply with the IRS rules and regulations. First, you should complete the §1031 exchange as you otherwise would if you were not married. In other words, you should take title to the replacement property in just your name. Then, using another portion of the tax code, you can "gift" a portion of the property to your spouse, free of any income tax or gift tax. The end result is that title is in both of your names.

Caution: Changing your "separate" property to "community" property often has substantial ramifications, especially in the event of one of your deaths or if you ever divorce. Be certain that you understand *all* consequences of your decision before you act. Consult your attorney, tax advisor, or estate-planning advisor for more details.

#### **EARNEST MONEY DEPOSITS:**

**Q:** When I locate my replacement property, can I use funds being held by the §1031 facilitator for the earnest money deposit?

**A:** Yes. The §1031 facilitator will be the "purchaser" of the replacement property. Accordingly, it is acceptable if the facilitator makes the earnest money deposit.

**Q:** I already signed a deal for my replacement property. I put \$10,000 of earnest money down. I really could use the cash right now. Is there a way to get the money back?

**A:** Yes, there is. If you find the replacement property and make the earnest money deposit, then when you assign the earnest money agreement to the facilitator as part of the §1031 exchange, the facilitator can "replace" your earnest money with the facilitator's earnest money.

#### **INVESTMENT HOLDING COMPANIES:**

**Q:** After I sell my investment property, I want to purchase another property with 3 other investors. Can I do this?

**A:** Yes, but you must proceed very carefully and there are some pitfalls. To start with, as long as the value of your share of the replacement property is equal to or greater than the value of the relinquished property, and all other requirements of a §1031 exchange are met, you still qualify for §1031 treatment. If you sold your existing investment property in your own name, be certain that you purchase the new replacement property in your name as well.

**Q:** I don't fully understand. The three investors and I would also like to form an LLC (limited liability company) or corporation to have title to the property. Can we do this also?

**A:** Be careful how you take title to the replacement property. As a general rule, the taxpayer that sells the relinquished property must be the exact same taxpayer that purchases the replacement property. This is sometimes referred to as the "identical taxpayer rule."

So, you cannot sell your relinquished property as part of a §1031 exchange, then form an LLC or corporation, and have the LLC or corporation take title to the replacement property. The reason is that you sold one property, and a completely different "taxpayer" purchased the other property. You (through your §1031 facilitator) must be the seller and you (again through the facilitator) must be the buyer.

The law does allow you, after taking title to the replacement property, to contribute the property to a corporation without the transfer being a taxable event. However, since you have an ownership interest in the corporation, the corporation is considered a "related party." This, in turn, triggers a series of restrictions upon you. As a general rule, the corporation must continue to own the property for at least 2 more years for you to preserve the §1031 treatment.

The treatment of contributing property to an LLC is a bit unclear. LLCs are relatively new creatures in the eyes of the law. To further complicate matters, taxpayers can have LLCs taxed as sole proprietorships, as partnerships, or as corporations.

Also, consider whether or not the LLC really serves your needs. Often holding the property as tenants in common and purchasing a solid, general liability insurance policy will achieve the same goals. Forming and operating an LLC, like any other "legal entity" takes time and money. Be certain it is time and money well spent.

## **GETTING CASH FROM CLOSING:**

**Q:** I really could use some of the proceeds from the sale of my rental property to pay some bills. Can my facilitator pay these bills for me?

**A:** No. To do so will put you at risk of losing the benefits of a §1031 transaction. The overall concept behind a §1031 is that all sale proceeds are "rolled over" into your new property. Using any part of the sale proceeds in a manner inconsistent with this concept puts you at risk.

Some taxpayers used to "pull money out" of the §1031 by obtaining a loan against their relinquished property just prior to its sale. This loophole has been closed by the IRS. You can, however, use the equity in your replacement property *after* the §1031 exchange is fully completed, to obtain a loan. This is the better course for you to follow.

## **FACILITATION FEES AND CHARGES:**

**Q:** I found a §1031 facilitator who will do my exchange for free or a nominal charge. What's the catch?

**A:** If it sounds too good to be true.... Clearly understand the fee you will be charged before you enter into any §1031 facilitation agreement. There is a good probability that the agreement provides that the facilitator will retain all interest earned on the sale proceeds. This interest can add up quickly, depending on the amount and how long the money is held in trust. Some facilitators advise taxpayers that "the IRS does not allow you to receive the interest." Years ago, this used to be the law, but no longer. You are entitled to receive the interest on the money held in trust, if you want it.

**Q:** I was told by a §1031 facilitator that there is a two-year representation rule regarding use of a facilitator. What does that mean?

**A:** The facilitator is probably referring to one of the requirements to fall within the IRS' "safe harbor" provisions and some technical restrictions on use of a "related party" as part of the §1031 transaction. A §1031 facilitator must be "independent" of the taxpayer. The IRS' regulations state that if the facilitator (such as an attorney) has represented the taxpayer within the past 2 years, the facilitator will not be considered a "qualified intermediary" or "qualified facilitator." This does not necessarily mean that the person cannot facilitate the §1031 exchange. This means that if you do so, you will not be within the "safe harbor" and, therefore, not automatically qualify for §1031 treatment. The burden would be on you to prove that your facilitator was not your "agent" or subject to your direction and control. As a general rule, play it safe — stay within the "safe harbor" provisions of the IRS regulations.

## REVERSE EXCHANGES:

**Q:** I have found a property that I really want to buy. The trouble is, it's going to take some time to fix up and sell the rental property I now have. Can I do a §1031 exchange?

**A:** You cannot do a traditional type of §1031 exchange. That type of exchange requires you to sell your existing property first, and purchase a new property later.

However, as of September 2000, you can structure your deal as a “reverse §1031 exchange.” The process is a bit complicated. Basically, it involves a “title accommodation holder” taking title to the property you now want to buy, and then you and the title accommodation holder participating in a more traditional type of §1031 exchange when you sell your existing property.

Be forewarned – a reverse §1031 exchange is more complex and, thus, much more expensive than a regular §1031. Know all of the risks and costs of doing a reverse exchange before you jump into one. And ask yourself if the property you want to buy really that great of a deal. Sometime they are. Sometime investors simply get caught up in the moment.

## REPAIRS OR IMPROVEMENTS TO REPLACEMENT PROPERTY:

**Q:** I have found a property with great potential, but it needs a fair amount of repairs. However, the property's asking price is lower than what I just sold my replacement property for. Can I use some of the money from the exchange to fix up the place?

**A:** The situation you are referring to is sometimes called an “improvement exchange.” An improvement exchange can be very tricky. If you just use some money from the sale of your relinquished property to make the repairs *after* you purchase the replacement property, then that money will be taxable as “cash boot.” The tax deductions for the repair costs may or may not be enough to offset the tax liability for this “cash boot.”

The trick is to use the sale proceeds to make the repairs *before* you take title. There are a few different ways of accomplishing this goal. The first way is to negotiate a purchase contract that requires the seller of the replacement property to make the repairs for you, with a corresponding increase in the purchase price. If the seller is very cooperative, the seller might allow you to select the contractors to do the work and oversee the work. Some sellers will want a larger earnest money deposit. Some will also want that earnest money released to them as non-refundable, to avoid the risk of them paying for the repair work out of their own pocket, and then having you decide later not to purchase the property. Some sellers will also approve direct payments from the exchange facilitator to the contractors.

A second way is to have a holding company take title to the replacement property, and then have that holding company handle the repairs. Using a holding company can reduce the complications and risks of having the seller do the repairs for you, since the holding company can serve as a type of “super cooperative seller.” The holding company can give you the right to hire the contractors, oversee the work, and so forth. Then, when the repairs are done or you reach the 180-day time deadline, the holding company transfers title to you. (In some cases, you can take ownership of the holding company without the need for another transfer of title.) The downside of this option is the additional costs involved in forming the holding company and the transactional costs of conveying title twice – once from the seller to the holding company, and then again from the holding company to you.

**Q.** What if all of the repairs are not done by the day I take title, but the supplies and materials are on site or I have contracts for the remaining work to be done soon?

**A.** Unfortunately, only the value of the completed repairs at the time you take title are taken into account for §1031 exchange purposes. For example, if a kitchen countertop worth \$3,000 is laying on the floor and ready for installation at the time you take title, that countertop is not yet considered part of the real property. When the countertop is laying on the floor, it is personal property. As soon as the countertop is set in place and fixed to the cabinets, then it becomes part of the real property. Only the value of real property is considered for §1031 exchange purposes.<sup>4</sup>

**Q.** So I can I then have a house built on land I found, and still qualify for an exchange?

**A.** Yes. About the only difference in having something built versus repaired is timing. Most repairs can be done in a matter of weeks or a few months. New construction typically takes much longer. So, while the basic concept of an “improvement exchange” is the same whether the work involves minor repairs to an existing building, a major remodel, or construction of a new building, the risk is much higher when new construction is involved, primarily because of the 180-day time limit for taking title.

## **COMPUTATION OF TAXABLE GAIN:**

**Q:** I am selling my rental property for \$200,000. I owe \$50,000 against it. I have \$150,000 of gain, right?

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<sup>4</sup> The one exception to this rule is if the personal property is reasonable and necessary for operation of the real estate and is of relatively nominal value. In that case, the value of the personal property is included in the value of the real property. Laundry equipment and janitorial supplies using in an apartment building is the most common example of this exception.

**A:** Probably not. It would be sheer coincidence if the amount of cash you expect to receive from the sale of the property equaled the taxable gain.

When computing your taxable gain, forget about how much you owe on any mortgage. There is no relationship between the taxable gain and how much money you owe against the property.

In general, taxable gain is the adjusted gross selling price, less your adjusted tax basis in the property. Your adjusted tax basis is, roughly, the price you paid for the property, plus any capital improvements you made, less any depreciation you have taken over the years. For example, if you bought your rental property for \$100,000, added a new roof last year at a cost of \$10,000, and have taken depreciation deductions of \$20,000, your adjusted tax basis would be \$90,000 (\$100,000 + \$10,000 - \$20,000). If your costs of sale total \$18,000, then your adjusted sales price will be \$182,000. Thus, your taxable gain would be \$92,000 (\$182,000 net sales price - \$90,000 adjusted tax basis). These computations can be further complicated by a concept called “recapture” income and “net investment income” taxes. The only sure way to compute the amount of gain is to meet with your accountant or tax preparer and “crunch the numbers” in detail.

### **“BOOT” AND TAX ON “BOOT”:**

**Q:** I want to downsize. Do I *have* to buy a property worth as much or more than the property I just sold?

**A:** Yes, at least if your goal is to defer all taxes on the transaction. The IRS rules say that you cannot receive any cash from the sale, otherwise it is subject to tax as “boot.” (Don’t ask me where the IRS came up with this term as I have no idea, but that’s what they call it). Similarly, the IRS says you must borrow as much against the new property as you paid off against the old one, otherwise you will have “mortgage boot” and that is subject to tax also. When you combine these two rules (*i.e.*, use all of your cash and borrow the same or more), the end result is that you must buy a property equal to or more than what you sold. You cannot “downsize” your investment property and still avoid taxes.

**Q:** Suppose I do downsize. Suppose I sell my rental property for \$200,000, but end up buying another one for only \$175,000. I owe tax on the \$25,000 difference, right? At a 15% capital gain rate, I owe \$3,750, correct?

**A:** As long as your total gain would have been \$25,000 or less, you are generally correct. Under IRS rules and regulations, you pay tax on the difference, whether that difference is cash in your pocket or just a lower mortgage on the new property. Also note, tax on capital

gains is based on a sliding scale. In this particular case, if you had no other income for the tax year, your capital gain tax might be as low as \$-0-.

However, be careful about making general assumptions regarding the total taxes you are going to owe. As noted, there are different marginal tax rates on capitals gains. Plus, depreciation recapture income, net investment income tax, and a Medicare surtax might all be imposed. You might also have some capital loss carryforward that might offset all of your gain. The best way to determine how much, if any, tax you would owe, is to consult your tax preparer, CPA, accountant, or other tax advisor.

# **FEE SCHEDULE**

## **§1031 EXCHANGE**

### **QUALIFIED INTERMEDIARY SERVICES**

Fees are effective until December 31, 2021 and may be subject to change thereafter.

No sales tax is due on any of the fees.

#### **GARY KROHN**

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| <b>§1031 EXCHANGE SERVICE</b>                                                                            | <b>FEE</b> |
|----------------------------------------------------------------------------------------------------------|------------|
| "Safe Harbor" Deferred Exchange of Real Property<br>(1 Relinquished property and 1 Replacement property) | \$1,031    |
| Each additional Relinquished or Replacement property                                                     | \$500      |
| Two-Party Non-deferred (Simultaneous) Trade of Real Property                                             | \$1,031    |
| Reverse Exchange – Exchangor provides exchange accommodation<br>titleholder                              | \$2,031    |
| Reverse Exchange – Exchange accommodation titleholder provided<br>by Intermediary                        | \$3,031    |
| Simultaneous or Deferred Exchange of fishing vessel or fishing<br>permit                                 | negotiable |