



## AN OVERVIEW OF TAX DEFERRED EXCHANGES

### INTRODUCTION

"1031 exchanges" and "Tax Deferred Exchanges" are terms that are commonly used to refer to exchanges of real estate without having to pay capital gains taxes. The exchange provisions are found in Code Section §1031 of the Internal Revenue Service Code, which accounts for the name.

IRC §1031 permits a taxpayer to exchange property held for a productive use in a trade or business or as an investment for property of a "like-kind" without any current recognition of income and the payment of capital gains tax on that income, subject to certain limitations.

### WHY CONSIDER A TAX DEFERRED EXCHANGE?

The primary reason for anyone to do an exchange is to *defer* capital gains tax and to be able to reinvest all the cash and other equity without having to pay the IRS! The associated benefits are as follows:

- Our clients are able to convert non-income producing property (such as raw land) to real estate that can produce revenue (such as a rental).
- Our clients are able to relocate investment property closer to where our clients are living now.

- Our clients are able to improve the quality of their property investment by relocating it to another more favorable investment location and earn higher appreciation on our client's investment.
- Our clients are able to exchange one property for several, or vice versa
- Our clients are able to decrease their management responsibility by acquiring a property under a triple net lease or in a retirement/vacation community.

Recently, a client who had once lived in a foreign country asked us, "Does this mean the government basically loans us the money we would have paid in taxes to use towards the purchase of new property? And we never have to pay it back unless we sell that property within our lifetime?"

*The answer is yes!*

## OUR CLIENTS DON'T HAVE TO SWAP

Our clients do not have to buy property at the same time our clients sell another property. A "Delayed Exchange" allows our clients to sell now and buy Replacement Property at a later time.

There are some interesting ways to plan an exchange: For instance, our client can sell one property to one party and buy Replacement Property from another. Our client can sell one property and buy two, three or more Replacement Properties.

Example: Our client sells a \$450,000 waterfront lot under the rules for a tax deferred exchange. Our client can then buy a \$50,000 condo rental; a \$100,000 parcel of raw land; a \$150,000 duplex, and a \$200,000 commercial building and *pay no capital gains taxes* so long as our client does so under the tax deferred exchange rules. Our clients have the opportunity to sell several properties and buy only one property with the sales proceeds. In this instance, our client may sell a triplex, a single-family rental home and acreage for \$400,000, and with the proceeds buy an office building for \$500,000, and still pay no capital gains taxes!

## TAX DEFERRED EXCHANGES UNDER THE TAX CODE

Under §1031 of the Internal Revenue Code, no gain or loss is recognized when property held for productive use in a trade or business or for investment is "exchanged" solely for property of "like-kind" which is held either for similar productive use in a trade or business or for investment. Receipt of "other property or money" (i.e., "boot") in a tax-deferred exchange results in recognition of gain to the extent of boot received. Like-kind tax deferred exchanges postpone depreciation recapture except to the extent of boot received.

## OUTLINE OF THE §1031 REQUIREMENTS

### I PROPERTY HELD FOR PRODUCTIVE USE IN A TRADE OR BUSINESS OR HELD FOR INVESTMENT

In order to qualify for like-kind exchange treatment, the property must be held for productive use in a trade or business or for investment. This requirement excludes property held for sale to customers in the ordinary course of business or owned by a "dealer" whose activities of only holding the properties for resale "taint" his property from qualification under this section. The acquired property must also be held for one of these purposes.

## II "LIKE-KIND" PROPERTY

Property of a like-kind does not mean property of the precise same type (e.g., an apartment building exchanged for an apartment building). The only requirement is that the property exchanged must be real property for other real property. This rule permits the exchange of improved real property for unimproved real property. A long-term lease of real property (exceeding 30 years) qualifies as real property for exchange purposes.

## III WHAT PROPERTIES QUALIFY?

This area can be very confusing. But very simply, any real estate used for business, trade or investment purposes will qualify. Examples include: apartment buildings, office buildings, multiplexes, single family or condo rentals, raw land, farms, ranches, commercial and industrial properties. All of these qualify! A lot adjoining a primary residence may also qualify if it is considered investment property.

#### IV MIX AND MATCH PROPERTIES

Our clients are not restricted to exchanging for real property similar or identical to our client's present property. The IRS allows our client to exchange raw land for an apartment building or a commercial mall, or a condo rental as long as the transaction is structured as a tax deferred exchange. As long as our client is selling (wanting to exchange) real property used for business, trade or investment purposes, our client can buy (exchange it for) any other type of business, trade or investment property. For example, our client can sell our client's self-operated gas station (trade real estate portion only; not business portion) and buy an apartment building (real-estate portion) and pay no capital gains taxes!

#### V WHAT PROPERTIES DON'T QUALIFY?

Internal Revenue Code § 121 affects our client's "primary residence." The home our client lives in will not qualify for an exchange because they cannot mix IRC §1031 with §121. In other words, our client cannot sell their home and use the proceeds to buy business or investment property without paying capital gains taxes. Nor can they sell business or investment properties and buy a primary residence to live in shortly after acquiring it without paying capital gains taxes. Remember, all of the properties our client exchanges out of and exchanges into in a tax deferred exchange must be trade, business or investment properties.

Certain properties are specifically excluded from the non-recognition rules of IRC §1031. The rules do not apply to an exchange of:

- Stock, in trade or other property held primarily for sale;
- Stocks, bonds or notes;
- Other securities or evidences of indebtedness or interest;

- Interests in a Partnership (subject to election under subchapter "K");
- Certificates of trust or beneficial interest; and,
- Chooses in action (Lawsuits).

## VI "BOOT" RECEIVED IN A TAX DEFERRED EXCHANGE

Income must be recognized in a like-kind exchange to the extent that "Boot" is received. "Boot" is the cash or other consideration, including relief from indebtedness, that benefits an exchanger when the items exchanged do not have equal exchange values. If gain is recognized, depreciation will also be recaptured ("if applicable") to the extent that any capital gain is recognized until the depreciation previously taken is fully recaptured.

### Example:

A and B each own properties of a like-kind. A wants to swap his property for B's property. A's property is worth \$200,000.00 and is subject to a mortgage of \$100,000.00. B's property is worth \$100,000.00 and is not mortgaged. Assuming that A's basis in the property to be exchanged is equal to \$100,000.00, then A will recognize \$100,000.00 of gain on the exchange which will not be deferred. We assume, of course, that the properties will meet the test for "like-kind".

If both properties are mortgaged, the mortgages will be netted and only the net amount of the mortgage outstanding on one side of the transaction will be treated as boot to the party who is relieved from the greater mortgage liability.

This principal may be illustrated by the following example: A owns property worth \$200,000.00 with a \$120,000.00 mortgage. B owns property worth \$200,000.00 with a \$100,000.00 mortgage. In the exchange, A is treated as realizing \$20,000.00 worth of boot from the exchange.

## VII THE ROLE OF TAX DEFERRED EXCHANGE SERVICES IN OUR CLIENTS EXCHANGE

- A. As we are specialists in this area, we are equipped to provide current information to the industry on the laws affecting tax deferred exchanges.
- B. We evaluate and provide an opinion on the possible methods of accomplishing the tax deferred exchange objective for our clients.
- C. We assist our client's accountants, attorneys and financial advisors in providing our client's proper evaluation of whether or not they should enter into such a transaction. The ultimate decision, however, lies with the client upon the advice of their personal accountant or attorney. We do not take the place of our client's accountant or attorney.
- D. We assist our client's escrow and title company and real estate professionals by providing all of them with all the needed documentation necessary to properly provide our client with exchange treatment.
- E. We coordinate our client's transaction to meet the strict deadlines imposed by the I.R.S.
- F. We review all the documents prepared for our client's various transactions to be certain that each transaction is completed properly.
- G. We provide accounting services for the exchange and a complete summary of the transaction when the exchange is completed to assist with our client's filing of their tax returns.
- H. Our fees are generally on a flat-fee basis and are paid from the proceeds of the closing of our client's first sale transaction.

## AN EXCHANGE SCENARIO

### 1. WHAT PARTIES ARE NEEDED FOR A §1031 EXCHANGE?

(A) An Exchangor

A party with a desire to sell property that he presently owns and which he holds for a trade or business or for investment and has a desire to acquire new property after that property sells.

(B) A Seller

A party who wishes to sell his property and is willing to pay capital gains tax on his sale.

(C) A Buyer

A party who wishes to purchase property presently owned by the exchangor.

(D) A Qualified Intermediary

A company who will structure and document the exchange so that the Internal Revenue Service will accept the transaction as a qualified tax deferred exchange.

### 2. WHAT TAKES PLACE UNDER THIS SCENARIO?

In the first leg of this type of exchange, the buyer purchases the exchangor's duplex for \$100,000.00. An Exchange Agreement is entered into between the exchangor/seller and the Qualified Intermediary allowing the exchangor/seller to assign the Purchase Agreement to the Qualified Intermediary. During the closing procedures, the Qualified Intermediary acts as the seller of the duplex. Upon the completion of the sale, the proceeds are distributed by the closing agent or Title Company to the Qualified Intermediary to hold for the purpose of purchasing one or more Replacement Properties. At this point the buyer is effectively out of the transaction. The buyer owns the duplex and has paid the

purchase price to the Qualified Intermediary. The exchangor has not received any money from the transaction.

The exchangor now has 45 days to locate "like-kind" properties. When properties are identified (within the allowable 45 days) this is the beginning of what we call the "second leg". At this point the parties have an additional 135 days after the 45 day declaration period (a total of 180 days) to complete the exchange. The exchangor enters into a Purchase and Sale Agreement in his or her name with "and/or assigns" with the seller (for example for a triplex worth \$150,000.00). Once this agreement has been signed, the exchangor by a written document assigns the Purchase and Sale Agreement (typically within the escrow closing) to the Qualified Intermediary.

The Qualified Intermediary now purchases the seller's triplex with the funds that it is holding in the exchange account from the duplex buyer and an additional \$50,000.00 cash deposit from the exchangor. The deed to the triplex is "direct-deeded" from the seller to the exchangor. The second leg of the transaction is now complete.

The outcome of the two steps is as follows: The buyer has purchased the exchangor's duplex for \$100,000.00 (his initial and only concern). No money has passed to the exchangor. A seller, with a triplex for sale for \$150,000.00 has been located and has subsequently sold his triplex. That seller will pay capital gains taxes, if any, on this sale in the normal manner. The triplex is, through direct deeding,

transferred to the exchangor fulfilling his desire to trade-up from his duplex to a triplex. By virtue of the fact that the exchangor received no money from the sale of his duplex, nor did he ever have any control over the proceeds from the sale, §1031 of the Internal Revenue Code allows him to postpone any tax liability. If the tax basis of the duplex sold was \$50,000.00 then the exchangor's basis in the triplex will be \$100,000.00. (The basis of the old property plus the cash paid for the new property).

The key elements that must be adhered to in order for the transaction to be deemed an "exchange" are:

- (A) There must be a properly drafted Exchange Agreement in place between the exchangor and the buyer of the exchangor's property to show intent;
- (B) There also must be a properly drafted Exchange Agreement between the buyer and the Qualified Intermediary;
- (C) Finally, the exchangor cannot have a right to sell for cash or receive cash.

## THE LAWS ARE CONSTANTLY CHANGING

The laws for exchanging change from time to time. If our clients have any questions as you read this literature, please contact our office at (800) 236-4948.

THIS LITERATURE IS PRODUCED TO PROVIDE A GENERAL OVERVIEW OF THE TAX-DEFERRED EXCHANGE PROCESS. OUR CLIENT SHOULD NOT DEPEND UPON THIS LITERATURE WHEN DETERMINING WHETHER OR NOT OUR CLIENT MAY WANT TO COMPLETE A TAX-DEFERRED EXCHANGE. OUR CLIENT'S DECISION TO DO SO RESTS ENTIRELY WITH OUR CLIENT, WITH THE ADVICE OF OUR CLIENT'S OWN ACCOUNTING AND LEGAL PROFESSIONAL, WHETHER THAT BE OUR CLIENT'S ACCOUNTANT, C.P.A. OR ATTORNEY. WE ARE QUALIFIED INTERMEDIARIES AND ARE BY I.R.S. REGULATION PRECLUDED FROM ACTING AS OUR CLIENT'S QUALIFIED INTERMEDIARY IF WE HAVE BEEN OUR CLIENT'S ATTORNEY OR ACCOUNTANT DURING THE TWO (2) YEAR PERIOD BEFORE OUR CLIENT'S EXCHANGE. AS OUR CLIENT CAN SEE, OUR SERVICES AS FACILITATOR DO NOT REPLACE THE TRULY PROFESSIONAL SERVICES OF OUR CLIENT'S ATTORNEY OR ACCOUNTANT!