WHAT IS IRC § 1031 EXCHANGE & HOW TO APPLY IT

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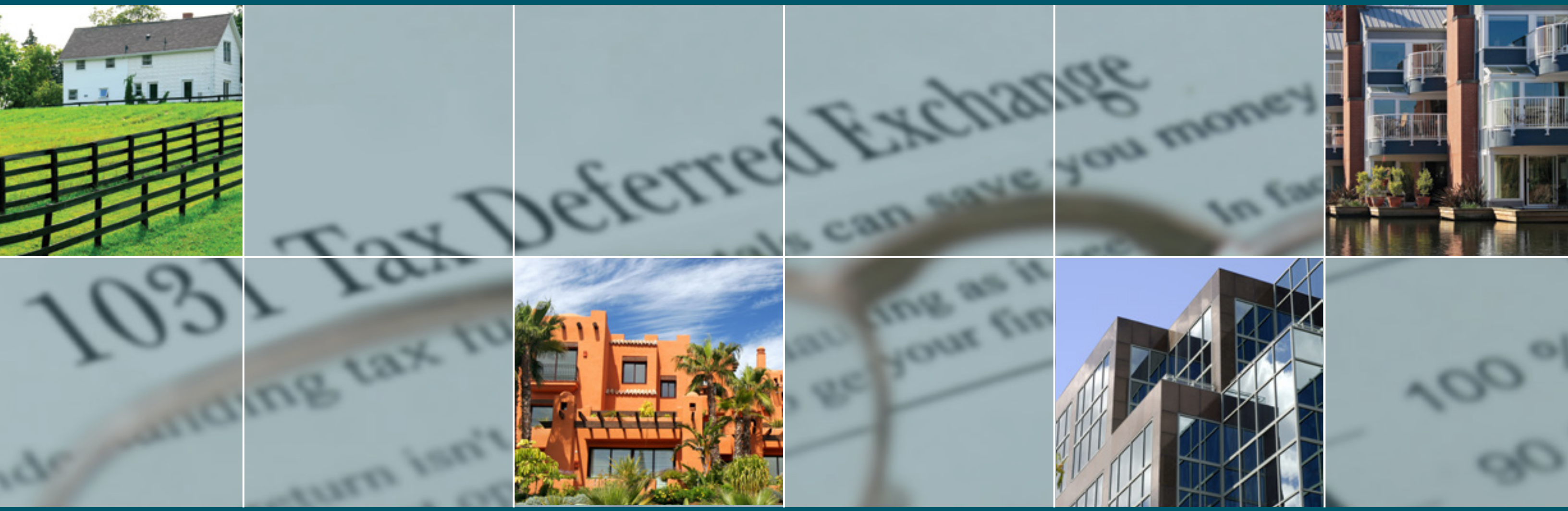

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NATIONAL REALTY EXCHANGE SERVICES

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FORWARD: SELLERS TAKE NOTICE!

There is no reason to pay any of your hard-earned profit to Uncle Sam in the form of tax on CAPITAL GAINS as long as you intend to invest all of your current equity in other qualifying property.

READ ON TO FIND OUT:

- Which properties qualify for non-recognition treatment
- How an exchange transaction actually works
- How easy it is to postpone the payment of taxes and
- What you need to do to comply with the tax code and the regulations

This course outlines a procedure for postponing the recognition of taxes on capital gain income upon disposition of real estate held for business or for investment.

IT EXPLAINS:

- How to eliminate unnecessary taxes,
- How to retain all of your profit and equity and
- How to get, in effect, an interest-free loan from the Federal government.

WARNING:

DO NOT convey your property or accept a proceeds check before you read this course material. You MAY NOT convert a sale into a qualifying exchange after the fact. You MUST NOT accept a proceeds check if you desire to qualify for tax treatment pursuant to Internal Revenue Code Section 1031 (IRC §1031).

Yes! We can amend your executed purchase and sale agreement to qualify the transaction for an exchange and establish your intent to exchange. We need forty-eight (48) hours' notice before the scheduled closing.

Under Section 1031 of the United States Internal Revenue Code (26 U.S.C.§ 1031), a taxpayer may defer recognition of capital gains and related Federal and State income tax liability on the exchange of real property.

DEFINITION OF A REAL PROPERTY 1031 EXCHANGE

No gain or loss shall be recognized on the exchange of REAL property held for productive use in a trade or business or for investment if such property is exchanged solely for REAL property of like-kind which is to be held either for productive use in a trade or business or for investment.

Whenever you sell business or investment property and you have a gain, you generally have to pay tax on the gain at the time of sale. IRC Section 1031 provides an exception and allows you to postpone paying tax on the gain if you reinvest the proceeds in similar property as part of a qualifying like-kind exchange. Gain deferred in a like-kind exchange under IRC Section 1031 is tax-deferred, and sometimes called "tax-free exchanges," because the exchange transaction itself is not taxed if you buy replacement property of equal or greater value.

The exchange can include like-kind property exclusively or it can include like-kind property along with cash, liabilities and property that are not like- kind. If you receive cash, relief from debt, or property that is not like-kind, however, you may trigger some taxable gain in the year of the exchange.

There can be both deferred and recognized gain in the same transaction when a taxpayer exchanges for like-kind property of lesser value. In an exchange, a property owner simply transfers the old property and receives the new property. However, the exchange must be structured in such a way that it is, in fact, an exchange of one property for another. A taxpayer is deemed to have sold property in a taxable transaction if the rights and interests in the property are conveyed and the taxpayer is in actual or constructive receipt of the proceeds. Consequently, a taxpayer who transfers title to property to the buyer and takes possession of the proceeds to purchase the new property has sold property in a taxable transaction and will not be afforded the benefits of an exchange.

The taxpayer may avoid the taxable sale and purchase and qualify for exchange treatment if, prior to the sale of the old property, the taxpayer enters into an exchange agreement with a "Qualified Intermediary," a fourth- party principal who helps to ensure that the exchange is structured properly and meets all of the requirements of IRC§1031 and the regulations, and pursuant to the exchange agreement, assigns all of his/her rights in and to the sale agreement to the Intermediary.

WHO QUALIFIES

Owners of investment and business property may qualify for a Section 1031 deferral. Individuals, C corporations, S corporations, partnerships (general or limited), limited liability companies, trusts and any other taxpaying entity may set up an exchange of business or investment properties for business or investment properties under Section 1031.

HISTORY

When income taxes were first imposed in 1919, gain or loss recognition was required on all dispositions of property. Provision for non-recognition of gain or loss on the exchange of property was introduced in 1921 when the United States Congress created Section 202(c) of the Internal Revenue Code. Limitations on the scope of exchange activities were imposed in 1923 by excluding stocks, bonds, notes, and choses in action, trust certificates and other securities from the non-recognition provisions of the Revenue Act of 1921. The Section number applicable to tax-deferred like-kind exchanges was changed to Section 112(b)(1) with the passage of The Revenue Act of 1928 and a 1954 Amendment to the Federal Tax Code changed the Section 112(b)(1) number to Section 1031 of the Internal Revenue Code and adopted the current definition and description of a tax-deferred like-kind exchange.

The substantive provisions of I.R.C. § 1031 remained basically the same until The Tax Reform Act of 1984 where time limits were introduced for non-simultaneous exchanges and interests in partnership were added to the types of properties excluded from non-recognition treatment. The 1984 change to the code was a direct result of the Starker decisions made in 1979 by the Ninth Circuit Court of Appeals which established the legal precedent that there could be a delay between transfer of ownership of the Relinquished and receipt of the Replacement. The Starker litigation originated from two delayed exchanges where T.J. Starker and son Bruce Starker sold timberland to Crown Zellerback, Inc. in exchange for the promise to acquire and transfer title to properties identified by T.J. Starker and Bruce Starker within five years. The IRS disallowed this, stating that a delayed exchange did not qualify. Prior to this, exchanges were completed as simultaneous transactions. These tax court decisions were significant and set the precedent for our present day delayed exchange transactions. The Starker cases demonstrated that non-simultaneous, delayed exchanges will qualify for tax deferred treatment, which provided greater flexibility in structuring a tax- deferred exchange transaction hence the Delayed 1031 Exchange was born.

IRS Section 1031 Timeline

History & Statutory Development

1913 — 16th Amendment Ratified

"Congress shall have the power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several states, and without regard to any census or emmeration."

The first Form 1040 was introduced.

1918 — Revenue Act of 1918

The Act codified all existing tax laws and income taxes were first imposed.

Gain or loss recognition was required on all dispositions of property

1921 — Revenue Act of 1921

The original 1031 exchange was legislated into law with the Revenue Act of 1921. The Act provided a provision for nonrecognition of gain or loss on the exchange of property.

1923 — Limitations Imposed on Activities

Limitations on the scope of exchange activities imposed in 1923 **excluded stocks, bonds, notes, choses in action, trust certificates and other securities** from the nonrecognition provisions of the Revenue Act of 1921. The code remained without much change until 1984.

1979 — Starker Decision

The Starker decision made in 1979 by the Ninth Circuit Court of Appeals which established the legal precedent that there could be a delay between transfer of ownership of the RZ and receipt of the RP.

1984 — Tax Reform Act of 1984

Time limits were introduced for non-simultaneous exchanges and interests in partnership were added to the types of properties excluded from non-recognition treatment.

1989 — Budget Reconciliation Act of 1989

The Act added 1031(f) that stated exchanges between related parties would continue to qualify for deferral of gain provided neither the exchanger or the related person disposes within two years the property received in the exchange.

Additionally, the 1985 Act added that property inside US and outside US are not properties of like-kind.

1990 — 1990 IRS Ruling

In April of 1990 an IRS Revenue Ruling authorized the use of direct deeding.

IRS Form 8824 was published to simplify reporting of an exchange.

1991 — IRS Publishes Final Regulation

Published May 1, 1991, the IRS's final regulation gives specific and clear guidance for the conduct of a tax deferred exchange.

Covers role of the qulified intermediary, assignment of contracts, control of escrow funds, and identification requirements.

2000 — "Safe Harbor" Established

In Octover 2000, the IRS Revenue procedure 2000-37 was published to provide the rules to accommodate a reverse exchange. This "Safe-Harbor" procedure provides for an Exchange Accommodation Titleholder (EAT). The EAT can purchase the relinquished property or the desired replacement property so the taxpayer can proceed with the exchange.

2017 — Tax Cuts and Jobs Act of 2017

Under the Act, Section 1031 now only applies to exchanges of real property. Effective Janurary 1, 2018, exchanges of machinery, equipment, vehicles, artwork, collectibles, parents and other intellectual property and intangible business assets generally do not qualify for non-recognition of gain or loss as like-kind exchanges.

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Under the Tax Cuts and Jobs Act of 2017, Section 1031 now applies only to exchanges of real property and not to exchanges of personal or intangible property. Thus, effective January 1, 2018, exchanges of machinery, equipment, vehicles, artwork, collectibles, patents and other intellectual property and intangible business assets generally do not qualify for non- recognition of gain or loss as like-kind exchanges.

TAX BASIS, GAIN & DEPRECIATION

The IRS requires you and your tax representative to adjust and track basis correctly to comply with Section 1031 regulations. Gain is deferred, but not forgiven, in a like-kind exchange. In order for the IRS to keep track of the profit/gain, you must calculate and keep track of your basis in the new property you acquired in the exchange. The basis of property acquired in an exchange is reduced by the amount of the net profit from the sale of the relinquished property so effectively the basis in the newly acquired replacement property is the basis of the property given up minus cost of sale plus any increase in value from the old property to the new property including the cost to acquire it. This transfer of basis from the relinquished to the replacement property preserves the deferred gain for later recognition if the exchanger eventually sells the relinquished property without reinvesting in additional property. ***The tax will be deferred throughout the exchangers lifetime and their heirs will receive a step-up in cost basis upon death effectively eliminating the capital gain and depreciation recapture taxes altogether.***

TAXATION RATES

Taxes the Real Estate Investor faces:

15% - 20%	4.75%	25%	3.8%
Capital Gains Tax (Federal Rate)	North Carolina State Income Tax	Depreciation Recapture (Federal)	NIIT or Net Investment Income Tax (formerly Medicare Surtax) (Federal)

FEDERAL AND STATE CAPITAL GAIN TAX

A capital gain is realized when a capital asset is sold or exchanged at a price higher than its basis. Basis is an asset's purchase price, plus acquisition costs and the cost of improvements, minus depreciation. Similarly, a capital loss occurs when an asset is sold for less than its basis.

Capital gains are classified as long term if the asset was held for more than one year, and short term if held for a year or less. Single Taxpayers with annual income of less than $44,725 pay no tax on long-term gains on most assets; taxpayers with annual income from $44,725 to $578,125 face a 15 percent rate on long-term capital gains until the profit from the sale increases their income above the threshold of $44,725 and then they will owe tax on the remainder of the profit. For taxpayers with income over $578,125 the rate is 20 percent. Short-term capital gains are taxed at the same rate as ordinary income. Married filing jointly with income under $89,450 pay no tax on the portion of the profit that, added to their ordinary income, would equal less than the $89,450 threshold. Married filing jointly taxpayers with income from $89,451 to $693,750 pay 15% capital gains tax and Married filing jointly taxpayers with income over $693,750 pay 20% capital gains tax.

C corporations pay the regular corporation tax rates on the full amount of their capital gains and may use capital losses only to offset capital gains, not other kinds of income.

Each state has their own individual state capital gains tax except for AK, FL, NV, NH, SD, TN, TX, WA and WY. The North Carolina State Income Tax for 2023 is 4.75%.

DEPRECIATION RECAPTURE TAX

Some capital assets can be depreciated for tax purposes, spreading the cost of an asset over a period of time for purposes of tax deductions. As a result, depreciation reduces the asset's adjusted cost basis. When the asset is subsequently sold, the gain on the sale will be more because its basis is now lower. How the gain is treated depends on the type of asset in question and in our case business use or investment properties are allowed depreciation and when sold the depreciation recapture tax is applied.

Depreciation recapture can cause a significant tax impact when you sell a residential rental property. Part of the gain is taxed as a capital gain and may qualify for the 15% or 20% (if you are in the highest tax bracket) on long-term gains, but the part that is related to depreciation is taxed at 25%. The technical term for gain related to depreciation on residential property is Unrecaptured Section 1250 Gains.

Any passive activity losses that were not deductible in previous years become fully deductible when a business use or investment property is sold. This can help offset the tax bite of the depreciation recapture tax. Avoiding claiming depreciation won't help. It

might seem reasonable that you could avoid claiming depreciation as a strategy to avoid the recapture tax hit because it must be recaptured when the asset is sold. This strategy doesn't work because tax law requires that recapture be calculated on depreciation that was "allowed or allowable," according to IRC Section 1250(b)(3). In other words, you were entitled to claim depreciation even if you didn't so the IRS treats the situation as though you had. From a tax- planning perspective, taxpayers should generally claim depreciation on property to get the current associated tax deduction because they'll have to pay tax on the gain due to the depreciation anyway when they eventually sell.

NET INVESTMENT INCOME TAX

In January of 2013, the funding for Healthcare and Education Reconciliation Act of 2010 took effect. This is a 3.8% surtax on "net investment income" based on the taxpayer's adjusted net income. It is assessed on single taxpayers earning over $200,000 or taxpayers married filing jointly on income over $250,000 counting the profit from the sale of the property. This tax is now called the Net Investment Income Tax or NIIT for short. Some refer to it as the Medicare Surtax or the Obama Care Tax because it was adopted during his administration to stabilize the Social Security Administration. NITT Tax is also deferred under the IRS §1031 tax deferred exchange.

COMPUTING TAX BASIS ON INVESTMENT PROPERTIES

Your real estate's tax basis is what you paid for the property and all of its capital improvements. This is usually different from the property's purchase price. The property's tax basis comes into play when the property sells because capital gains taxes are calculated on the difference between the tax basis and the final selling price. Investors, though, have to pay attention to a property's basis for the entire time that they own it because depreciation is calculated relative to the tax basis. You take the original purchase price that you paid for the property and in our example we will use $500,000 as the purchase price of the property you acquired. At the time you purchased the property you added capital improvements that cost $50,000. Capital improvements aren't maintenance and repair expenses such as cosmetic paint and carpeting. Think about anything that will add value like a new roof, an addition and or remodeling. We are using 27.5 years straight line depreciation (commercial property is depreciated over 39 years). We take the value of the improvements and divide it by 27.5 years. This is the allotted amount of depreciation per year you can write off. In our example, the property was valued at $550,000 (land $100,000 and improvements $450,000). We divide the $450,000 by 27.5 years, giving us depreciation of $16,364 per year. In our example, we depreciated 10 years.

$500,000	original purchase price
+ $50,000	capital improvements
$550,000	
– $163,640	Depreciation
$386,360	**Adjusted basis**

CALCULATING THE GAIN

First, you have to sell the property. Take your sales price and subtract the closing costs and the adjusted basis. In our example, our sales price was $1,200,000 and the closing costs were $80,000 and the adjusted basis was $386,306 and you get $733,640 in taxable gain.

$1,200,000	sales price
– $80,000	closing cost
– $386,306	Adjusted basis
$733,640	**taxable gain**

CALCULATING THE TAX DUE

First you start with the amount of depreciation taken which, in our example, was $163,640 and multiply by 25% to get the unrecaptured depreciation tax; then subtract the depreciation from the taxable gain and multiply that amount by 20% to get the Capital Gains Tax (as our buyer was in the highest income bracket); then take the taxable gain and multiply by 3.8% to get the NIIT tax; and finally take the taxable gain and multiply by the 4.75% to get the NC state tax; add these all together to determine the total tax liability to the Exchangor of $217,636. Should the Investor sell and pay the tax or exchange?

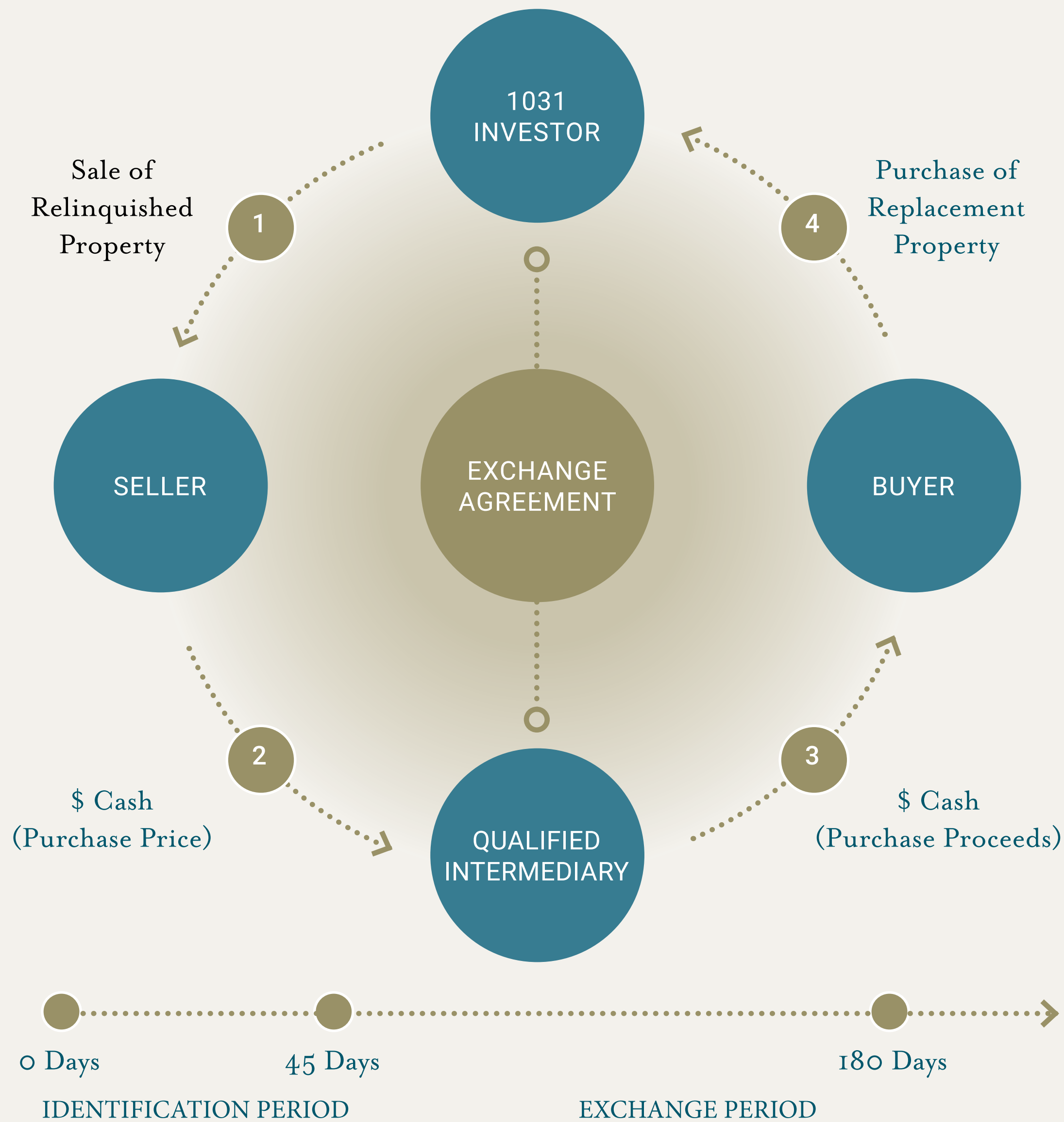
$40,910	Unrecaptured Depreciation Tax – 25%
$114,000	Capital Gain Tax – 20% (highest bracket)
$27,878	NIIT (net investment income tax) – 3.8%
$34,848	NC State Tax – 4.75%
$217,636	**Total Tax**

THE QUALIFIED INTERMEDIARY SAFE HARBOR

The role of the Qualified Intermediary(QI) is essential to completing a delayed exchange. The QI is the conduit between the buyer and seller of the property to form the exchange. The QI, otherwise known as an accommodator or a facilitator, cannot be considered the agent of the taxpayer for constructive receipt purposes.

In order to take advantage of the QI safe harbor there must be a written agreement between the taxpayer and QI limiting the taxpayer's rights to receive, pledge, borrow or otherwise obtain the benefits of the money or property held by the QI.

The QI is defined as a person who is not the taxpayer or a disqualified person who enters into a written agreement with the taxpayer and, as required by the exchange agreement, acquires the relinquished property from the taxpayer, transfers



the relinquished property, acquires the replacement property, and transfers the replacement property to the taxpayer.

The Internal Revenue Code prohibits related parties such as accountants, attorneys and real estate agents who have worked for the taxpayer within the prior two years from serving as a QI.

LIKE-KIND PROPERTY

Properties are of like-kind if they're of the same nature or character, even if they differ in grade or quality. Real properties generally are of like-kind, regardless of whether they're improved or unimproved. For example, an apartment building would generally be like-kind to another apartment building. However, real property in the United States is not like-kind to real property outside the United States.

THE PURPOSE REQUIREMENT

Although every type of real property located within the 50 United States, and the U.S. Virgin Islands is like kind to all other real property similarly located and is therefore eligible for tax-deferred treatment, there is an additional provision relating to the property which must also be met, called *the purpose requirement*. The Internal Revenue Code (IRC) §1031 stipulates that "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." This means that to qualify for tax-deferred treatment, the relinquished property must be held by the taxpayer for productive use in a trade or business or for investment and in the exchange, the taxpayer must acquire property which he or she intends to hold for productive use in a trade or business or for investment. All real property that is rented to others at fair market rent and all property held by the taxpayer for use in a trade or business is property held for the productive use in a trade or business. The store where the taxpayer conducts his hardware business, the multi-unit apartment building, the rented single-family home or residential condominium, the shopping mall are all examples of qualifying property held by the taxpayer for the productive use in a trade or business.

However, if the taxpayer moves into the single-family home, or rents it for below market rates, the property is considered property held for personal use and no longer qualifies for exchange purposes. Property held for investment by the taxpayer is property held primarily for the incremental increase in value due to factors beyond the control of the taxpayer. The best example of real property held for investment is raw undeveloped land which the taxpayer acquired for long-term hold and appreciation. Thus any real property, other than the taxpayer's personal use property (property held as the taxpayer's personal residence or second home) or dealer property (property acquired for resale) qualifies and meets the Purpose Requirement for an exchange.

NON-QUALIFYING PROPERTY

Finally, certain types of property are specifically excluded from Section 1031 treatment. Section 1031 does not apply to exchanges of:

- Principal residence
- Speculation property held for re-sale
- Second or vacation homes
- Inventory or stock in trade
- Stocks, bonds, or notes
- Other securities or debt
- Partnership interests
- Certificates of trust

TWO BASIC EXCHANGE RULES TO DEFER GAIN

In order to avoid all tax you must buy equal to or greater in value minus cost of sale and you must use all the cash from the sale of the relinquished property. The IRS requires the net market value and equity in the new property purchased to be the same as, or greater than the property sold to defer all tax. For our example, you sold a property worth $500,000, with a mortgage of $250,000. To receive the full benefit of the 1031 exchange, the new property or properties you purchase need to have a net worth of at least $500,000, and you'll have to use all the cash from the sale and borrow $250,000 through a mortgage loan or substitute additional cash rather than borrow funds. It's important to note that the $250,000 cash from the sale of the relinquished property goes directly to the Qualified Intermediary (QI) at closing and all of it must be used towards the purchase of the replacement property. Any cash out to the exchangor from the relinquished property sale will be taxed at the highest rate. The cash proceeds must be held by the QI until transferred to the replacement property closing agent at the time of purchase or the 180 day exchange periof expires. The 180 day exchange period begins on the day after the closing of the Relinquished Property (RQ). Also please note the exchangor may purchase more than one replacement property as long as the total purchase price of all the replacement properties together equal or exceed the sales price of the relinquished property minus cost of sale. Customary closing costs and fees including brokerage commissions, attorney's fees transfer tax and document preparation will reduce the target price of the replacement property or properties. Finally please note again that you may substitute additional cash for a portion or all of a mortgage loan.

CASH AND MORTGAGE BOOT

The Taxpayer or Exchangor must not receive boot from an exchange in order for a Section 1031 exchange to be completely tax free. Any boot received is taxable to the extent of gain realized on the exchange. This is acceptable when a seller desires some cash and is willing to pay some taxes. Otherwise, boot should be avoided in order for a 1031 exchange to be tax free.

The term boot is not used in the Internal Revenue Code or the Regulations, but is commonly used in discussing the tax consequences of a Section 1031 tax-deferred exchange. Boot received is the money or mortgage relief received by the taxpayer in an exchange. Money includes all cash equivalents received by the taxpayer. Mortgage boot is any net debt reduction which occurs as a result of the exchange taking into account the debt on the relinquished property and the replacement property. Boot can be inadvertent and result from a variety of factors. It is important for a taxpayer to understand what can result in boot if taxable income is to be avoided.

THE EXCHANGE EQUATION

FOR FULL TAX DEFERREL, A TAXPAYER MUST MEET TWO REQUIREMENTS:

1. Reinvest all net exchange proceeds to acquire the new property.
2. Acquire property of equal or greater value iminus cost of sale.

	RELINQUISHED	REPLACEMENT	BOOT
Value	$900,000	$1,200,000	
Debt	$300,00	$660,000	$0
Cost of Sale	$50,000		
Net Equity	$540,000	$540,000	
Total Boot			$0

The taxpayer acquired property of greater value, reinvesting allnet equity and increasing the debt on the replacement property.

Analysis: There is no boot.

	RELINQUISHED	REPLACEMENT	BOOT
Value	$900,000	$700,000	
Debt	$300,00	$260,000	$40,000
Cost of Sale	$60,000		
Net Equity	$540,000	$440,000	$100,000
Total Boot			$140,000

The taxpayer acquired property of a lower value, keeps $100,000 of the net equity and acquired a replacement property with $40,000 less debt.

Analysis: The results in a total of $140,000 in boot.
($40,000 mortgage boot and $100,000 in cash boot = $140,000)

EXCHANGE TYPES

The different structures of a Section 1031 Exchange. To accomplish a Section 1031 exchange, there must be an exchange of properties. The simplest type of Section 1031 exchange is a Simultaneous Exchange or swap of one property for another and is the only exchange type that does not require a Qualified Intermediary (QI).

DEFERRED OR DELAYED EXCHANGES

These exchanges are more complex but allow flexibility. They allow you to dispose of property and subsequently acquire one or more other properties. To qualify as a Section 1031 exchange, a deferred exchange must be distinguished from the case of a taxpayer simply selling one property and using the proceeds to purchase another property which is a taxable transaction. Rather, in a deferred exchange, the disposition of the relinquished property and acquisition of the replacement property must be mutually dependent parts of an integrated transaction constituting an exchange of property. Taxpayers engaging in deferred exchanges under safe harbor requirements must use qualified intermediaries operating under exchange agreements pursuant to the safe harbor rules provided in the regulations.

THE CONSTRUCTION OR BUILD-TO-SUIT EXCHANGE

Also referred to as a construction or improvement exchange, this exchange gives the exchanger the opportunity to use exchange funds for construction, renovations or new improvements, to the replacement property. In the most common type of build-to-suit exchange, the exchanger sells the relinquished property through a QI in a delayed exchange, and then acquires the replacement property after it has been improved using the exchange funds from the relinquished property sale. Note that any improvements made to the replacement property after the exchanger takes title are not considered like-kind. To qualify for inclusion in the exchange, any improvements to the property must occur before the exchanger takes title. Any unused exchange funds may be taxable as boot. Only funds disbursed for material actually in place and services actually performed will count toward the exchange value. Exchange funds in an escrow “holdback” for post-closing improvements will not qualify even if the funds are deposited before the Exchanger takes title.

A REVERSE EXCHANGE

This exchange is somewhat more complex than a deferred exchange. It involves the acquisition of replacement property through an exchange accommodation titleholder, with whom it is parked for no more than 180 days. During this parking period, the taxpayer disposes of its relinquished property to close the exchange.

EXCHANGE TIME LIMITS

The Tax Reform Act of 1984 imposed time restrictions for exchanges.

45

45 DAY IDENTIFICATION PERIOD:
The taxpayer must identify potential replacement property(s) by midnight of the 45th day from the date of sale.

180

180 DAY EXCHANGE PERIOD:
The taxpayer must acquire the replacement property by midnight of the 180th day, or the date the taxpayer must file its tax return (including extensions) for the year of the transfer of the relinquished property, whichever is earlier.

IDENTIFICATION RULES – ALTERNATIVE & MULTIPLE PROPERTIES

Whether one property or more than one property is transferred by the taxpayer as part of one exchange, the number of replacement properties that may be identified is:

- Up to three properties, without regard to their fair market value, (the "Three Property Rule"), or
- More than three properties, if the total fair market value of all these properties at the end of the 45-day identification period does not exceed 200% of the total fair market value of all property relinquished (the "200% Rule").
- If the taxpayer fails to meet either the three property rule or the 200% rule, then the taxpayer must acquire 95% of all property identified at the termination of the 45-day identification period (the 95% Rule).

If the taxpayer fails to meet the requirements of one of the rules, the 3 property rule or the 200% rule or the 95% rule, then all property acquired in the exchange will be deemed not to be like kind. The exchange shall fail by virtue of the fact that the taxpayer received only non-like kind property and gain will be recognized to the full extent of the realized gain.

STRUCTURING THE DELAYED EXCHANGE

A delayed exchange is the most common exchange format, providing investors the flexibility of up to a maximum of 180 days to purchase a replacement property. The use of a QI is required to complete a valid delayed exchange. The QI prepares the necessary exchange documents to assist the taxpayer with meeting the many detailed requirements, as well as avoiding numerous destructive pitfalls.

SALE OF THE RELINQUISHED PROPERTY

Prior to closing the sale of the relinquished property, the taxpayer enters into the exchange agreement. Pursuant to the exchange agreement, an assignment is executed prior to closing, and the QI assumes the exchanger's purchase and sale agreement. The QI instructs the closing/escrow officer or closing attorney to directly deed the property from the exchanger to the buyer. Proceeds are transferred directly to the QI, thereby protecting the exchanger from actual or constructive receipt of funds.

IDENTIFICATION OF REPLACEMENT PROPERTY

The taxpayer must properly identify potential replacement properties within 45 calendar days after the date of the closing of the first or only relinquished property.

PURCHASE OF THE REPLACEMENT PROPERTY

The taxpayer has a total of 180 calendar days from closing of the relinquished property, or their tax filing date, whichever is earlier, to acquire like-kind replacement properties. Prior to closing on the replacement property, the taxpayer assigns the purchase and sale agreement to the QI. After the assignment is executed, the exchange is completed when the QI purchases the replacement property with the exchange proceeds and transfers it back to the taxpayer by a direct deed from the seller.

STRUCTURING THE CONSTRUCTION OR BUILT-TO-SUIT

If the exchanger wishes to include construction on the replacement property as part of the exchange, one option is to contract with the seller to have the construction completed before the transaction closes and the exchanger takes title to the property. For a variety of reasons, this is often not a viable option. Revenue Procedure or Rev. Proc. 2000-37 provides a "safe harbor" for structuring a build-to-suit exchange using an Exchange Accommodation Titleholder (EAT) to hold title to the replacement property pending completion of the improvements. Time limitations and all other rules of IRC §1031 apply to build-to-suit exchanges. The identification notice in a Build-To-Suit Exchange should include a description of the underlying real estate and as much detail regarding the improvements as is practical. To avoid boot, the exchanger must ultimately acquire replacement property with a value equal to or greater than the value of the relinquished property, and use all of the exchange equity in the acquisition of the improved replacement property.

As in a typical delayed exchange, the build-to-suit exchange involves a QI and begins when the exchanger sells the relinquished property. Prior to closing on the purchase of the replacement property, the exchanger enters into a qualified exchange accommodation agreement (QEAA) with the EAT and assigns its rights in the purchase contract to the EAT. The EAT then acquires title to the replacement property. The QI or the EAT holds all parked properties in a separate special purpose holding entity (typically a single member LLC) for each exchange (the EAT and holding entity are jointly referred to as the EAT). The exchanger or its designated representative is authorized by the EAT to act as its project manager to oversee all aspects of the construction. During the 180-day exchange period, the exchanger, as project manager, sends construction invoices to the EAT for payment. The EAT must make payments directly to the vendors.

Build-to-suit exchanges are less complicated when the improvements can be paid for with cash loaned to the EAT by the exchanger or with exchange funds advanced by the QI. If a construction loan from an institutional lender is required, the exchanger should seek lender approval prior to beginning the exchange, since the EAT, as titleholder to the replacement property, may be required to be the "borrower" on the loan. To protect the EAT from liability in the event of default by the exchanger, the EAT will require the loan to be non-recourse as to itself. Lenders typically require the exchanger to guarantee a loan made to the EAT.

On either the end of the 180-day Exchange Period or completion of construction on the replacement property, the EAT will transfer the replacement property to the exchanger to complete the exchange. Depending upon the exchanger's preference, the replacement property is often transferred to the exchanger by assignment of the sole membership interest in the holding entity rather than by a deed. Selecting the appropriate method for transfer of title should be determined after review of transfer tax and other legal issues by the exchanger's tax and legal advisors. If a third-party lender is involved, the exchanger typically will assume the construction loan upon the conclusion of the exchange. Any construction to be included in the exchange must be completed and paid for prior to the holding entity's transfer of the replacement property to the exchanger. Rev. Proc. 2000-37 also permits the exchanger to use an EAT to close on the purchase of the replacement property and commence construction of improvements, prior to the sale of the relinquished property. In reverse build-to-suit exchanges, since the relinquished property has not yet sold, the exchanger or a third- party lender must loan funds to the holding entity to acquire and improve the replacement property.

STRUCTURING THE REVERSE EXCHANGE

In a reverse exchange structured under the safe harbor protection of Rev. Proc. 2000-37, the entity used to facilitate a reverse exchange is referred to as an Exchange Accommodation Titleholder (EAT), and the property held by the EAT is commonly called the parked property. The QI holds all parked properties in a separate special purpose holding entity typically a single member LLC for each Exchange. The EAT and holding entity are jointly referred to herein as EAT. To complete a reverse exchange, the EAT will take title to either the Relinquished Property or the Replacement Property under a Qualified Exchange Accommodation Arrangement(QEAA).

TIME PERIODS

The same 45-day identification period and 180 day deadlines of IRC §1031 apply to a safe harbor reverse exchange under Rev. Proc. 2000-37, with a slight tweak. If the EAT has begun the exchange by acquiring the replacement property, then the exchanger must identify within 45 days after acquisition of the parked property, one or more relinquished properties to be exchanged for the replacement property. The same identification rules apply which require that written identification be delivered to another party to the exchange, such as the EAT or the Qualified Intermediary, and limits the number of alternative and multiple properties that can be identified. The identified relinquished property must be sold, and the parked replacement property transferred to the exchanger to complete the exchange within 180 days of parking the replacement property with the EAT.

REPLACEMENT PROPERTY PARKED

In the most common type of reverse exchange, the EAT acquires and parks legal title to the replacement property. In the first phase of the reverse exchange, the exchanger or a third-party lender loans the funds necessary for the EAT to purchase and take title to the replacement property. The EAT leases the property to the exchanger under a triple net lease. This permits the Exchanger to receive the economic benefits and burdens of the property during the time that it is held by the EAT.

When the Exchanger sells the identified relinquished property, title is transferred directly to the buyer through direct deeding. The cash proceeds of the sale go to the QI, which uses these exchange funds to acquire the replacement property from the EAT. Upon receipt, the EAT will first repay the loan from the exchanger and then use remaining exchange funds to pay down the third-party loan on the replacement property prior to transferring the parked property to the exchanger. If the relinquished property sale yields more exchange funds than necessary for the QI to acquire the parked property, the exchanger may identify additional replacement property within 45 days of the transfer of the relinquished property, and complete the additional acquisition within 180 days of the relinquished property transfer.

REPLACEMENT PROPERTY PARKED – LOANS TO EAT

This type of reverse exchange works well when the exchanger can pay all cash for the replacement property, when the seller is providing the financing, or when an exchanger is working with a third-party commercial lender. If a loan from an institutional lender is required, the exchanger should seek lender approval prior to beginning the reverse exchange because the EAT, as the titleholder of the property, may be required to be the borrower on the loan. Exchangers should be aware that many lenders are not familiar with reverse exchanges, many types of loans are not available when pursuing a reverse exchange, and the loan costs may be increased to cover the lender's document preparation and legal fees. To protect the EAT from liability in the event of default by the exchanger, the EAT will require the loan to be non- recourse as to itself. Lenders typically require the Exchanger to guarantee a loan made to the EAT.

RELINQUISHED PROPERTY PARKED

An alternative to parking the replacement property is to park the exchanger's relinquished property with the EAT. Since the EAT does not have its own funds to purchase the relinquished property, it must borrow the money. The consideration consists of the EAT taking the relinquished property subject to the existing third-party financing, and a purchase money loan from the exchanger. For a fully deferred exchange, the loan from the exchanger should equal the equity the exchanger has in the relinquished property.

A relinquished property parked reverse exchange begins with a simultaneous exchange involving the exchanger, the EAT, the seller of the replacement property, and the QI. The exchanger transfers the relinquished property to the EAT and simultaneously receives the replacement property from the seller. Both transfers occur through the QI and the use of direct deeding. The funds the EAT borrowed from exchanger will be used to pay closing costs, with any balance flowing through the exchange and being applied toward the purchase of the Replacement Property.

The cash proceeds from the sale of the relinquished property go to the EAT and are used first to retire any existing third-party debt the EAT took subject to, and then to repay the exchanger for the original loan to the EAT. If the price paid by the EAT for the parked property differs from the actual price paid by the ultimate buyer, the exchanger and the EAT will enter into a purchase price adjustment agreement to increase or decrease the original purchase price and loan amount from the exchanger as necessary to reflect the final purchase price.

BENEFITS OF 1031 EXCHANGE

A. Deferred Gain Treatment
B. Building Wealth
C. Depreciation
D. Consolidation
E. Diversification
F. Cash Flow
G. Marketing 1031 Exchange
H. Increase leverage
I. Co-ownership issues

TIC & DST OPTIONS

Tenant-In-Common (TIC) Investment Property Guidelines Introduced by IRS. The introduction of Revenue Procedure 2002-22 has arguably had the most significant impact on the 1031 Exchange industry since the Tax Reform Act of 1986. It provided investors with an additional replacement property option that had not existed before and some argue its responsibility for the explosive growth in the volume of 1031 exchange transactions during the mid 2000s. However, the recession period of the mid to late 2000s, forced some difficult lessons on lenders. Lenders are now very hesitant to lend under any TIC investment property, forcing investors to look to the Delaware Statutory Trust in order to get lenders on board.

Delaware Statutory Trusts (DSTs) Guidelines Introduced by the IRS Revenue Ruling 2004-86 paved the way for new ways for investors to invest in fractional or co-ownership interests in real property. Revenue Ruling 2004-86 now permitted **Delaware Statutory Trusts (DST)** to qualify as real estate and therefore as a replacement property solution for 1031 Exchange transactions. Investors could acquire a fractional or percentage interest in the Delaware Statutory Trust as a beneficiary in the DST. The DST is very similar to the TIC investment property but in a different legal wrapper, which will have its own nuances to be considered.

VACATION OR SECOND HOMES REVENUE PROCEDURE 2008-16:

- Creates a safe harbor for vacation home exchanges.
- IRS will consider a dwelling unit held for investment if certain requirements are met.

REQUIREMENTS:

- The relinquished and replacement properties are owned by the taxpayer for at least 24 months (the qualifying use period);
- Within each of these two 12 month periods constituting the qualifying use period the taxpayer must;
- Rent the property to another person or persons at fair market rent for 14 or more days (family members qualify if they use the property their primary residence); and
- The taxpayer's personal use of the dwelling unit cannot exceed the greater of 14 days or 10 percent of the time it is rented.

COMBINING SECTIONS 121 & 1031:

1031 Exchanges Can Be Combined with the primary residence 121 Exclusion under Revenue Procedure 2005-14 which was issued and made effective on January 27, 2005. This procedure made it possible for the first time for homeowners to use the tax-deferral mechanism of Section 1031 on their primary residence, if done in conjunction with specific strategy delineated under the Revenue Procedure.

So long as the property in question satisfies the requirements for both Code Sections 1031 and 121, then the Section 121 Exclusion operates to exclude from taxable income either 250,000 (single) or 500,000 (married) in capital gain from the sale, exchange or disposition of the property. Any additional gain may be deferred by reinvesting in like-kind replacement property through a like-kind exchange which benefits homeowners with gains over the $250,000 and $500,000 limits. Two common usages of Revenue Procedure 2005-14 are when a taxpayer converts their Primary Residence into an "Investment Property", or when a taxpayer treats a portion of a property as their Primary Residence and the remainder as an "Investment".

REFINANCING:

Typically, any refinancing after the exchange is completed has zero consequence on taxation or validity of the exchange. Any refinancing prior falls in a grey area. Most tax practitioners will give you a time frame of 2 years prior to refinance, but there isn't any definite time or regulations to refer to. Either refinance 2 years prior or after the exchange is completed.

VESTING:

For an exchange to satisfy IRC §1031, the taxpayer that will hold the title to the replacement property must be the same taxpayer that held title to the relinquished property. However, business considerations, liability issues, and lender requirements may make it difficult for the exchanger to keep the same vesting on the replacement property. Exchangers must anticipate these vesting issues as part of their advanced planning for the exchange.

EXCEPTIONS:

Exceptions to this rule occur when dealing with entities that are disregarded for federal income tax purposes. For example, the following changes in vesting usually do not destroy the integrity of the exchange:

1) The exchanger's revocable living trust or other grantor trust may acquire Replacement Property in the name of the exchanger individually, as long as the trust entity is disregarded for tax purposes.

2) The exchanger's estate may complete the exchange after the exchanger dies following the close of the sale of relinquished property.

3) The exchanger may sell relinquished property held individually and acquire replacement property titled in a single-member LLC or acquire multiple properties in different single-member LLCs as long as the exchanger is the sole member and the single member LLCs are treated as disregarded entities.

4) A husband and wife may exchange property held individually as community property for property titled in a two-member LLC in which the husband's and wife's ownership is community property, but only in community property states and only if they treat the LLC as a disregarded entity. The nine community property states are Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin. If the property is not located in a community property state it is suggested that both the husband and wife form separate single member disregarded LLC's and each LLC would then hold a 50% interest in the replacement property or wait for 2 years after replacement property acquisition in their names individually to transfer the replacement property into a partnership LLC.

5) A corporation that merges out of existence in a tax-free reorganization after the disposition of the property may complete the exchange and acquire the replacement property as the new corporate entity.

6) Illinois land trust is a disregarded entity for IRC §1031 purposes, so an Illinois land trust beneficiary may exchange his beneficial interest in property held by the trust for property vested in the beneficiary individually, or in a different Illinois land trust, as long as the exchanger is the beneficiary.

Adding a party to vesting, such as property held by husband, with property acquired by husband and wife, can result in partial recognition of gain by the husband. Divesting property held in one entity, such as a corporation, partnership, or multi-member LLC and acquiring the property in a different corporation, partnership, or multi-member LLC, or in the shareholders, partners or members individually, will disqualify the exchange because the exchange is being completed by a different taxpayer than the one starting the exchange. However, conversion of a general partnership to an LP or an LLC during the exchange will not disqualify the exchange.

ISSUES OF 1031 EXCHANGE

A taxpayer cannot take actual possession or be in control of the net proceeds from the sale of relinquished property in a 1031 exchange or this becomes realized gain and is a taxable event. The QI should be engaged prior to close of the sale of property.

CHOOSING A QI THAT ISN'T DISQUALIFIED

Adhering to the strict time limits of the 45 day identification period and 180 days to complete the transaction. The exception is in the case of presidentially declared disasters.

BEWARE OF SCHEMES

Taxpayers should be wary of individuals promoting improper use of like-kind exchanges. Typically, they are not tax professionals. Sales pitches may encourage taxpayers to exchange non-qualifying vacation or second homes. Many promoters of like-kind exchanges refer to them as "tax-free" exchanges not "tax-deferred" exchanges. Taxpayers may also be advised to claim an exchange despite the fact that they have taken possession of cash proceeds from the sale.

Consult a tax professional or refer to IRS publications for additional assistance with IRC Section 1031 Like-Kind Exchanges.

CHOOSING A QUALIFIED INTERMEDIARY

The QIs serves as a limited purpose depository institution to hold all of the exchange funds during the 1031 exchange. As a result, QIs hold substantial sums of money on behalf of their exchange clients. With the exception of a few states, including Nevada, California, Idaho, Colorado and Arizona, there are no federal or state regulations or supervision of Intermediaries. Obviously, the selection of a QI who will be entrusted with the funds is an important matter. QI's offer widely varying services and have widely varying professional training, skills and competence. QI's are usually attorneys, tax accountants, bank affiliates or title companies. Many QI's have no training as a tax professional or as an exchange professional and offer no consultation to a taxpayer on tax issues related to the exchange or on the technical requirements for completion of a successful exchange. Some Intermediaries simply bank funds. QI's fees differ and range from $1,050 to $2,200 for simple exchanges and from $8,500 to $12,000 for a Reverse or Construction Exchange. Most QI's hold exchange funds in demand escrow or trust accounts and do not pay interest on exchange funds. Due to technology, QI's can be located anywhere within the US. Emails, electronic or digital signing, faxing and funds wiring capabilities give the industry the opportunity to be anywhere and offer excellent service.

Here are some of the things taxpayers should consider when hiring the QI:

- The QI should have Certified Exchange Specialists capable of consulting you on 1031 tax issues.
- The QI deposits funds in FDIC insured demand deposit accounts with immediate availability.
- The Intermediary should be a member of the Federation of Exchange Accommodators, the industries professional organization that requires its members to perform services at the highest level of competence and trust.
- The QI needs to have experience, knowledge and an outstanding reputation.

CONCLUSION

The tax deferred exchange, as defined in §1031 of the Internal Revenue Code, offers taxpayers one of the last great opportunities to build wealth faster by preserving profits in the form of taxes. By completing an exchange, the taxpayer can sell investment or business-use properties, acquire replacement property and defer the tax that would ordinarily be due upon the sale. For a full deferral of the capital gain or recapture tax, you must acquire like kind property that will be held for investment or business use, purchase replacement property of equal or greater value, reinvest all of the equity into the replacement property, and transfer the same or greater debt on the replacement property. Your current mortgage may be replaced with additional cash, but cash equity cannot be replaced with additional debt.

Additionally, you may not receive cash or other benefits from the sale proceeds during the exchange.

IRC §1031 applies to all types of real property, but it does not apply to exchanges of stock in trade, inventory, property held for sale, stocks, bonds, notes, securities, evidences of indebtedness, certificates of trust or beneficial interests, or interests in a partnership.

An exchange is rarely a swap of properties between two parties. Most exchanges involve multiple parties, the exchanger, the buyer of the sale property, the seller of the new property, and a QI. To create the exchange of property and obtain the benefit of the Safe Harbor protections which prevent actual or constructive receipt of exchange funds, prudent taxpayers use a professional Qualified Intermediary such as National Realty Exchange Corporation.

Course attendees must attend at least 90% of the approved clock hours in order to qualify for continuing education credit. A sign in and sign out sheet will be provided. This course is approved for continuing education credit by the North Carolina Department of Real Estate. However, this approval does not constitute an endorsement of views or opinions which are expressed by the course sponsor, instructor, authors or lecturers.