

# **SECTION 1031 HANDBOOK**

YOUR GUIDE TO MAKING THE MOST  
OF YOUR INVESTMENTS

## **UNLIMITED EXCHANGE II**

15 North Main Street  
Temple, Texas 76501

866-597-9543

[Exchangeinfo@unlimitedexchange.com](mailto:Exchangeinfo@unlimitedexchange.com)

9/25/08

# SECTION 1031 HANDBOOK

## Table of Contents

	Page
<b>Introduction</b>	1
What is a 1031 Exchange?	1
Deferred Exchange v. Swap	1
Exchange Requirements Overview	2
Common Misconceptions	3
<b>Exchange Basics</b>	4
Capital Gain v. Equity	4
Substituted Basis	4
Boot and Taxable Gain	5
Exchanges Involving Installment Sale Notes	5
Construction of Replacement Property	6
Treatment of Earnest Money and Sales Proceeds	7
Replacement Property Issues	8
<b>Types of Exchanges</b>	9
Reverse Exchange	9
Simultaneous Exchange	9
Forward Delayed Exchange	9
Construction Exchange (Build-to-Suit Exchange)	9
Personal Property Exchange	9
<b>How to Select a Qualified Intermediary</b>	11
Qualified Intermediary Duties and Services	11
<b>Financing and 1031 Exchanges</b>	13
Relinquished Property – Seller Financing	13
Replacement Property – Financing and Refinancing	13

	Page
<b>Exchange Requirements for Non-recognition of Gain</b>	14
Qualified Properties	14
Real Estate Used in a Business	15
Real Estate Held for Investment	15
Like-kind Property	15
Excluded Assets	16
Partnership Interests	16
Transfer Between Spouses	16
Sale/Lease Back as an Exchange	16
Personal Property Business Assets	16
Vacation Homes	16
<b>Time Restrictions and Rules</b>	18
Replacement Property	18
Special Exception	19
Trade Even or Up in Value	19
Incidental Property	19
Identification of Replacement Property	20
Revocation of Replacement Properties	20
Receipt of Replacement Property	20
New Construction Replacement Property	21
Information Reporting to the Internal Revenue Service	21

# SECTION 1031 HANDBOOK

## INTRODUCTION

### What is a 1031 Exchange?

The Internal Revenue Code Section 1031 permits the deferral of capital gains taxes on the sale of property held for investment or productive use in a trade or business. It is one of the best real estate vehicles investors have for building and preserving real estate wealth. Section 1031 allows property Exchange Parties to exchange their property for other like-kind property without recognition of capital gains. The most important concept to remember in a 1031 Exchange is that both the property to be sold and the new property must be like-kind. Like-kind relates to the use of the properties not the description or the location of the property.

A few situations do not qualify for 1031 Exchanges, such as residential property the Exchange Party lives in or intends to live in or property he intends to resell. In general, it makes no difference what the use is as long as it is not the Exchange Party's primary residence.

The most common type of exchange is the Forward Delayed Exchange in which the property is sold and the proceeds are used to purchase another property within a certain period of time.

### Deferred Exchange v. Swap

People have exchanged properties for years. Frequently, an Exchange Party wants to sell but the other Exchange Party does not want to buy the Exchange Party's property. This creates a problem if both Exchange Parties want to dispose of property and avoid taxable gains.

In order to solve the dilemma, the IRS issued the long-promised deferred exchange regulation, Regulation 1.1031(k)-1 (the "Regulation"). The Regulation permits an Exchange Party to "sell" his Relinquished Property now and use the proceeds to buy the Replacement Property later. As long as the transaction follows the rules and uses the services of a Qualified Intermediary, the tax-deferred treatment in Section 1031 applies.

The Regulation is a taxpayer's dream come true. It works without the buyer of the Relinquished Property or the seller of the Replacement Property getting involved in the exchange. The Regulation's secret weapon is the creation of a legal entity called the Qualified Intermediary. The Qualified Intermediary is permitted to serve as an agent and perform all the exchange work for an Exchange Party without the Exchange Party's involvement in a taxable sale of the old property. By using a Qualified Intermediary to handle an exchange transaction, an Exchange Party can turn the sale of property, and subsequent purchase of another like-kind property, into a Section 1031 exchange.

The Regulation explaining how to put together a Section 1031 Deferred Exchange is a powerful tool and strategy for selling appreciated business, farms, land, and investment real estate without recognition of gain for income tax purposes. The Regulation provides step-by-step guidance for the sale of appreciated property, use of cash proceeds to buy a Replacement Property, and qualification for the full benefits of non-recognition of gain under Section 1031. The Regulation has the weight of law; all parties must follow its provisions (even the IRS).

The intent of the Deferred Exchange is that an Exchange Party has an actual continuation of his old property investment into the new replacement property. The rules and requirements of Section 1031 of the Internal Revenue Code must be followed explicitly.

### **Exchange Requirements Overview**

Section 1031 requires an actual exchange of properties. If an Exchange Party simply sells a property and reinvests the money in another property, he will not qualify for exchange treatment, even though it is a simultaneous close.

The secret of a successful Deferred Exchange is avoiding receipt of money or other property during the transaction. If an Exchange Party receives the cash proceeds from the exchange of property, he will not qualify for Section 1031 treatment. While this may sound easy to avoid, it is not. An Exchange Party must overcome the doctrine of "constructive" receipt.

The general rules concerning actual and constructive receipt apply to determine if an Exchange Party is in actual or constructive receipt of money or other property before he receives like-kind Replacement Property.

- An Exchange Party is in actual receipt of money or property at the time he actually receives the money or property.
- An Exchange Party also is treated as being in receipt if he receives the economic benefit of the money or property.
- An Exchange Party is in constructive receipt of money or property at the time the money or property is credited to the Exchange Party's account, set apart for the Exchange Party, otherwise made available to the Exchange Party such that it may be drawn upon it at any time, or if the Exchange Party can draw upon it if notice of intention to withdraw is given.
- Actual or constructive receipt of money or property by an Exchange Party's agent is actual or constructive receipt by the Exchange Party.

The Regulation provides a "safe harbor" that permits an Exchange Party to sell Relinquished Property, acquire Replacement Property, and avoid constructive receipt. This safe harbor is the written contractual agreement with a Qualified Intermediary.

## Common Misconceptions

The following are a few misconceptions in connection with Deferred Exchanges.

**Myth:** An Exchange Party must exchange one property for another simultaneously.

**Fact:** A one-for-one simultaneous exchange need not take place. In a Forward Delayed Exchange, the property is sold and Replacement Property is purchased within 180 days following the sale of the Relinquished Property. In a Reverse Exchange, however, the Replacement Property is purchased before the sale of the Relinquished Property.

**Myth:** The property purchased has to be the same type as the property sold to meet like-kind requirements.

**Fact:** Any real property is like-kind to any other property under the Section 1031 guidelines. This means that raw land can be like-kind to an office building.

**Myth:** A seller can hold the money from the sale of the property and use it to purchase Replacement Property without dealing with a Qualified Intermediary.

**Fact:** A Qualified Intermediary provides safe harbor protection for Section 1031 exchanges. Without a Qualified Intermediary, the IRS may review the exchange and a court could invalidate the exchange. A Qualified Intermediary must remain completely neutral and independent and cannot have been the Exchange Party's agent (lawyer, CPA, broker) in the past two years.

**Myth:** Section 1031 deadlines can be extended if necessary.

**Fact:** There are no extensions for either the 45- or 180-day rules (discussed later). An extension may be provided in cases of declared emergencies, such as national disasters or terrorist attacks.

**Myth:** Capital gains taxes that would otherwise be payable never have to be paid.

**Fact:** A Section 1031 exchange is a tax-deferral strategy, which means the taxes are not due when the sale occurs. The cost basis transfers from the Relinquished Property to the Replacement Property and, with strategic Section 1031 planning, it may be possible to turn the tax deferral into tax savings.

## EXCHANGE BASICS

### Capital Gain v. Equity

Do not confuse capital gain with equity; there is no comparison between the two. Equity is the amount of money a person has in his pocket after the sale of the property and all related liabilities and mortgages are paid. Capital gain is the difference between the basis and the adjusted sales price of a property (discussed below).

**Example without Mortgage:** An Exchange Party bought a property ten years ago for \$30,000; it is owned free and clear and has a basis of \$20,000. If he sold that property today for \$115,000, and paid \$15,000 in closing costs and commissions, he has equity of \$100,000. (Equity is the amount of cash an Exchange Party would take away from the closing.) However, capital gains on this property would be the difference between the basis of \$20,000 and the adjusted sales price of \$100,000, or \$80,000. Based upon the tax structure that exists in 2008, the capital gains tax would be \$12,000.

**Result:** If a person sells instead of doing a Section 1031 exchange, the Exchange Party would be obligated to pay a capital gains tax on the entire \$80,000.

**Example with Mortgage:** If an Exchange Party had mortgage of \$90,000 on this property, he would need to repay the loan at the time of closing. This results in net cash to the Exchange Party at the closing of only \$10,000 (\$100,000 less the loan payoff of \$90,000). But, the capital gains tax still would be \$12,000.

An Exchange Party must be extremely careful not to be trapped with a regular sale. In a case such as one outlined above, an exchange is the better recourse unless a person has additional funds to pay the taxes. In larger transactions with more money and leveraging, the situation only gets worse.

### Substituted Basis

Before entering into any exchange of real estate, an Exchange Party must calculate the basis of the Replacement Property to assess how it fits with his financial and tax plans.

Much depends on this basis. For example, if the Replacement Property is an apartment complex (Section 1231 property), an allocation must be made of the "new" basis to figure the amount qualifying for depreciation. This is the amount of the depreciation deduction. If unrecognized gain on the Relinquished Property is large, the basis of the Replacement Property will be very low compared to market values, and it can have unexpected results if not anticipated.

The operations statement for the apartment complex will reflect rental income based on today's market values. But the depreciation deduction will be based on "yesterday's cost". The Exchange Party needs to recognize this difference and accept it as part of the planning

before going ahead with the exchange. Basis is used as the base point for the calculation of capital gain on a transaction.

### **Boot and Taxable Gain**

Money and unlike property in an exchange are called boot. To figure taxable gain, an Exchange Party needs to determine the fair market value of the boot received. Then, he must calculate how much the gain would have been if the property had been sold in a regular taxable sale. The taxable gain is the smaller of these two amounts.

Receiving cash or other boot in a real estate exchange does not defeat the nontaxable provisions of Section 1031 for the like-kind property involved. If, in addition to the Replacement Property, an Exchange Party receives money or some other kind of property, he may have taxable gain. The good news is the Exchange Party is taxed only on gain that comes from the money and other boot received.

Figuring boot in exchange transactions becomes more complicated when one or both of the properties are mortgaged. If the other party assumes any of the mortgage liabilities as part of the exchange, the Exchange Party is treated as if he received boot in the amount of the mortgage balance. If an Exchange Party assumes or acquires mortgage liabilities as part of the exchange, the Deferred Exchange is treated as if he paid boot in the amount of the mortgage liabilities.

If each participant assumes the liabilities of the other, the liabilities of one are offset against the liabilities of the other. Only the excess is treated as net boot paid or net boot received. In other words, the mortgages are netted. An Exchange Party can deduct the mortgage assumed from the mortgage on the Relinquished Property.

**Example:** An Exchange Party exchanges Relinquished Property with an outstanding mortgage of \$124,000. The other party assumes this mortgage. The \$124,000 is treated as boot received by the Exchange Party. However, the Exchange Party assumes a mortgage on the Replacement Property in the amount of \$130,000. Since netting cannot be less than zero, the net boot received is zero and the Exchange Party is treated as paying boot in the amount of \$6,000 (\$130,000 minus \$124,000).

If the amount of the mortgage assumed was only \$110,000, the net boot received from netting the mortgages would be \$14,000 (\$124,000 minus \$110,000).

### **Exchanges Involving Installment Sale Notes**

There is an ingenious tax strategy that permits an Exchange Party to take back boot in a Section 1031 exchange without paying tax on it now. Gain from the boot can be deferred into future tax years. The deferral is accomplished by taking back a purchase money installment note from the "buyer" of the Relinquished Property to balance all or part of the equities. When structured correctly, the taxable gain in the note may be reported using the installment method of tax accounting.

An Exchange Party can use a purchase money installment note to acquire Replacement Property by trading it to the "seller" for part of the consideration for purchase of new property. This does not trigger the unrecognized gain in the installment note.

An Exchange Party can instruct the Qualified Intermediary to sell the note on the open market (the Exchange Party can negotiate this sale or have the Qualified Intermediary do it as agent) and add the amount realized to the exchange proceeds. This will give the Exchange Party all cash to negotiate the replacement purchase. This approach is less desirable because of the discount that might have to be given on the sale of the note, but it does not trigger the unrecognized gain in the installment note.

A party related to the Exchange Party, such as a closely held corporation or relative, can either purchase the installment note from the Qualified Intermediary or provide financing so that the Qualified Intermediary receives all cash at closing. An Exchange Party should consult with a tax advisor regarding structuring this type of transaction. This does not trigger the unrecognized gain in the installment note.

An Exchange Party can wait until the end of the exchange and receive the installment note back from the Qualified Intermediary. This will result in the note becoming "boot" and it will be taxable. However, at this point, the installment sale rules under Section 453 take effect and the Exchange Party is permitted by election to use the installment method of tax accounting and only recognize capital gain as principal payments are collected each year. Interest on the installment note is always taxable at ordinary income rates. The installment sale percentage for figuring gain is 100%.

### **Construction of Replacement Property**

One of the greatest stipulations in the Regulation permits an Exchange Party to exchange for real estate that includes improvements that have not been built yet. A transfer of Relinquished Property in a Deferred Exchange will qualify for non-recognition of gain or loss under Section 1031 even if the Replacement Property is not in existence or is being produced at the time the property is identified as Replacement Property.

To use this provision, Replacement Property to be produced must be identified. For example, the identified Replacement Property consists of improved real property where the improvements are to be constructed. The description of the Replacement Property will satisfy the requirements if a legal description is provided for the underlying land and as much detail as is practicable at the time the identification is made is provided for construction of the improvements. Two examples of identification of the property to be produced are blueprints and the contract with the builder.

To comply with the 200% and incidental property rules, the fair market value of the Replacement Property to be produced is its estimated fair market value as of the date it is expected to be received by the Exchange Party.

Variations due to usual or typical production changes are not taken into account in calculating this rule. However, if substantial changes are made in the property to be produced, the Replacement Property received will not be considered to be substantially the same property as identified.

If identified Replacement Property is real property that includes improvements to be constructed and the construction is not completed on or before the date an Exchange Party receives the property, the property received will be considered to be substantially the same property as identified only if it is real property; it would have been considered to be substantially the same property as identified had construction been completed on or before the date the owner received it.

The value of the Replacement Property must be calculated on the day of transfer. Construction work completed after the day of transfer will not be treated as part of the exchange.

There are two ways that new construction is handled in an exchange.

1. The Exchange Party may contract with a builder to purchase a property that will be completed and ready to close prior to the end of the 180-day exchange period. The Exchange Party may purchase the land prior to construction as a Replacement Property or he may purchase the land and building from the builder at the time of closing. This is the least expensive and easiest method for the Exchange Party.
2. The Exchange Party may contract for what is known as a "Build-out Exchange". Following this procedure, the Exchange Party, as the Exchange Party, finances all or part of the construction. Through a special agreement with a Qualified Intermediary, the builder draws on the exchange proceeds as certain steps of the construction are completed. This arrangement is more complicated and risky for both the Exchange Party and the Qualified Intermediary and usually will increase the cost of the exchange by \$1,500 or more.

In either case, the purchase and sale agreement should contain language that requires the builder to bear responsibility for the Exchange Party's taxes if the exchange fails due to the construction extending beyond the required 180-day exchange closing period. Any additional production or construction with respect to the Replacement Property after the Exchange Party receives the property will not be treated as the receipt of like-kind property.

Caution: Be very careful not to get caught in an exchange for services trap. The transfer of Relinquished Property will not qualify for Section 1031 treatment if it is transferred in exchange for services. This includes production services.

### **Treatment of Earnest Money and Sales Proceeds**

When selling Relinquished Property in a Section 1031 exchange, it is important to avoid actual or constructive receipt of the earnest money deposit. The earnest money should never be deposited in an account under the control of the Exchange Party. It should be deposited in an escrow account, with a real estate broker's trust account, or with a Qualified Intermediary. The earnest money receipt should state that the funds are to be assigned to the Qualified Intermediary and that the Exchange Party has no control or right to direct how these funds are to be used.

The best and safest way to make an earnest money deposit for the purchase of Replacement Property is from personal funds. Any unused funds brought into the Replacement Property transaction, other than exchange proceeds being held by a Qualified Intermediary, can be reimbursed at the time of closing. Exchange proceeds can only be used for earnest money if the purchase and sale agreement has been assigned in writing to the Qualified Intermediary and, even then, the funds from the exchange proceeds are not true earnest money since the funds can be released only to the seller at the time of closing. If the transaction fails to close, the funds will be returned to the Qualified Intermediary.

Proceeds from Relinquished Property not spent on the Replacement Property will be treated as boot received and taken into account when figuring the net boot received.

An Exchange Party can receive unused proceeds any time after acquiring all of the property identified in the 45-day identification time period. If not all property is acquired, the unused proceeds cannot be released until (1) the earlier of the due date of the Exchange Party's tax return, including extensions, or (2) 180 days after the closing of the sale of the Relinquished Property.

The Qualified Intermediary will return the Exchange Party's money at any time an Exchange Party decides to abandon the exchange or is unable to find Replacement Property to identify by the end of the 45-day period. There is no charge for the return of proceeds.

### **Replacement Property Issues**

**Multiple Properties.** An Exchange Party can combine multiple Relinquished Properties into one or more Replacement Properties. If the Relinquished Properties are transferred on different dates, the identification period and the exchange period for the entire exchange are measured from the earliest date on which any of the properties is transferred.

**Rental Properties.** There are no hard rules with regard to how long a rental Replacement Property must remain a rental property before it can be converted into a primary residence without risking the Section 1031 exchange benefits. The IRS requires that an Exchange Party show intent to use the Replacement Property as a rental; current opinion is that if the property is reported as rental on two or more consecutive tax returns, the Exchange Party has shown intent.

## TYPES OF EXCHANGES

### **Reverse Exchange**

A Reverse Exchange is a transaction in which the Replacement Property is acquired before the Relinquished Property is sold. This powerful tax-planning procedure permits an Exchange Party to acquire the Replacement Property under favorable circumstances before selling the Relinquished Property.

### **Simultaneous Exchange**

The original type of Section 1031 exchange, a Simultaneous Exchange is a transaction in which the Relinquished Property is sold and Replacement Property is purchased at the same time and at the same escrow office. A Simultaneous Exchange can be difficult logistically, especially with a complex transaction involving properties in different cities or states. Due to the nature of the transaction, only one party in the transaction is permitted a Section 1031 exchange.

### **Forward Delayed Exchange**

The most common type of exchange, the Forward Delayed Exchange occurs when a property is sold (Relinquished Property) and a property is purchased (Replacement Property) within 180 days following the sale of the Relinquished Property. For a safe harbor Forward Delayed Exchange, the sale proceeds must be held by a Qualified Intermediary between the sale of the Relinquished Property and the subsequent purchase of the Replacement Property.

### **Construction Exchange (Build-to-Suit Exchange)**

A Construction Exchange, or a Build-to-Suit Exchange, occurs when the Exchange Party uses the funds from the sale of the Relinquished Property to construct improvements on the Replacement Property. The property on which the improvements are constructed cannot be held by the taxpayer but must be held by a third-party called an Exchange Accommodation Titleholder until either the improvements are complete or until the end of the 180-day Exchange Period, after which the Exchange Party is deeded the Replacement Property with the improvements. Due to its complexity, a Construction Exchange incurs higher fees.

### **Personal Property Exchange**

Exchanges are not limited to real property. Personal property also can be exchanged for other personal property of like-kind or like-class. Currently, Personal Property Exchanges account for only 5% of Section 1031 exchanges.

Personal property exchanges range from exchanges of corporate jets, commercial aircraft, ships, and other individual, high-dollar products to fleets of automobiles, trucks, heavy equipment, and computer equipment. Intangible personal property, such as broadcast

licenses, copyrights, and franchise licenses, qualify for Section 1031 exchange treatment. Gold coins, paintings, and other collectibles also may be exchanged.

When selling a business, business Exchange Parties may exchange the individual assets of the business in a multi-asset exchange. Multi-asset exchanges often include both personal and real property and are a popular strategy used by individuals, investors, small businesses, and large corporations.

## HOW TO SELECT A QUALIFIED INTERMEDIARY

A Qualified Intermediary is a person (or company) who acts to facilitate an exchange by entering into an agreement with the Exchange Party for the exchange of properties. It is permissible for an Exchange Party's transferee to be his agent but only if the transferee is a Qualified Intermediary.

Security is the most important concern when selecting a Qualified Intermediary. The Qualified Intermediary is responsible for handling the transaction's funds, so the Exchange Party needs to be certain he can work closely with the chosen Qualified Intermediary. The Exchange Party also will want to be sure the Qualified Intermediary has the experience necessary to handle the transaction. A Qualified Intermediary will charge a fee for its services, so the Exchange Party will want to review the fees associated with the exchange.

The regulations describe the limited circumstances under which a Qualified Intermediary is treated as acquiring and transferring property regardless of whether, under general tax principles, the Qualified Intermediary actually acquires and transfers the property.

The Exchange Party or a disqualified person cannot qualify as a Qualified Intermediary for his own exchange; a person is a disqualified person if he is an agent of the Exchange Party at the time of the transaction. Agents of the Exchange Party include any person who has acted as the Exchange Party's employee, attorney, accountant, investment banker or broker, or real estate agent or broker within the two-year period ending on the date of the transfer of the first of the Relinquished Properties. However, the Regulation disregards certain services for purposes of determining if an agency relationship exists. Performance of services with respect to exchanges of real estate intended to qualify under Section 1031 is not taken into account in determining an agency relationship.

Furthermore, performance of routine financial, title insurance, escrow, or trust services by a financial institution, title insurance company, or escrow company is not taken into account in determining if an agency relationship exists.

### **Qualified Intermediary Duties and Services**

One of the most important decisions to be made regarding an exchange is the choice of a Qualified Intermediary. In addition to knowing and understanding the safe harbors prescribed by the regulations, the Qualified Intermediary must be experienced in procedures and treatment of different real estate situations and requirements that occur in many exchange transactions. Mistreatment of these situations can be fatal to the exchange and result in a loss of Section 1031 tax-free treatment.

The Qualified Intermediary does not provide legal or specific tax advice to the Exchange Party but will usually perform the following services.

1. Coordinate with the Exchange Party and his advisors to structure a successful exchange.

2. Prepare the documentation for the Relinquished Property and the Replacement Property.
3. Furnish escrow with instructions to effect the exchange.
4. Secure the funds in an insured bank account until the exchange is completed.
5. Provide documents to transfer the Replacement Property to the Exchange Party, if applicable, and disburse exchange proceeds to escrow.

## **FINANCING AND 1031 EXCHANGES**

### **Relinquished Property – Seller Financing**

Seller financing on the Relinquished Property is considered boot, which means it is taxable in the year(s) that it is paid (or considered an installment sale). There is a possibility that seller financing can be placed into the exchange, but the note would have to be paid off or sold before the purchase of the Replacement Property or be used to purchase the Replacement Property.

### **Replacement Property – Financing and Refinancing**

Financing is not a problem on the Replacement Property provided the Replacement Property purchased is at least as valuable as the Relinquished Property sold and provided that all the exchange proceeds from the sale of the Relinquished Property are used to purchase the Replacement Property. The Exchange Party also can consider putting additional financing on the Replacement Property after the purchase and completion of the 1031 Exchange, but that should not be the intent of the Exchange Party when making the purchase. Financing simultaneous with the purchase that puts cash in the Exchange Party's pocket also could be taxable as boot.

## EXCHANGE REQUIREMENTS FOR NON-RECOGNITION OF GAIN

There are three conditions that must be met in order to accomplish non-recognition of gain under Section 1031:

1. The properties exchanged must qualify and be of "like-kind".
2. There must be an actual exchange, not merely a transfer of property for money only.
3. The time requirements must be strictly followed.

### Qualified Properties

To meet the requirements of Section 1031, both the Relinquished Property and the Replacement Property must qualify. In other words, both the property being sold **and** the property being purchased must be qualified property of like-kind. If not, the exchange will fail and be classified as a sale.

For income tax purposes, real estate is divided into four classifications:

1. Land held for business use (Section 1231),
2. Land held for investment (Section 1221),
3. Land held for personal use, and
4. Land held primarily for sale (dealer property).

Classification is made as of the date the transaction is effective.

The first two classifications – land held for business use and land held for investment – qualify for Section 1031 treatment. The second two classifications do not qualify for Section 1031 treatment.

Some properties have more than one classification at the time of sale. For example, a farmer sells his farm, including his personal residence. The sale or exchange is allocated between the real estate held for personal use (the personal residence) and the real estate held for use in a trade or business (the farm). Another example is the sale or exchange of a duplex where the seller lived in one unit and rented the other unit. The sale would be allocated.

Under Section 1031, both business and investment properties qualify; business property only for business property or investment property only for investment property is not required. For example, an Exchange Party may exchange an apartment house (business property) for two unimproved lots (investment property), or a commercial warehouse (business property) for a 60-acre tract of raw land (investment property). All could qualify.

Many real estate investors and professionals have difficulty distinguishing between business real estate and investment real estate. Remember, Section 1031 deals with taxation, not financial investments.

## **Real Estate Used in a Business**

Real estate used in a business is known as Section 1231 real estate. There are two types of real estate used in a trade or business.

1. Owner-occupied and the property is used in the Exchange Party's trade or business. Examples are a factory owned to produce products and a warehouse used to store inventory.
2. Rental income property. The act of renting the property qualifies it as property used in a trade or business. Examples are a factory property rented to a third-party and an apartment house rented to tenants as their residence.

Net gains from the sale or exchange of Section 1231 property are taxed as long-term capital gains. However, if the holding period is short, the gain may be recognized as ordinary income. Net losses are deductible as ordinary losses.

Real estate used in a trade or business qualifies for Section 1031 treatment when exchanged for other business or investment real estate.

## **Real Estate Held for Investment**

Real estate used in a trade or business is not held for investment. Similarly, real estate held for personal use is not held for investment.

Investment real estate is a capital asset (Internal Revenue Code Section 1221). It is property held primarily for appreciation of value due to location, passage of time, and other factors outside the activities of the Exchange Party. It is treated as a portfolio investment asset. An example of investment real estate is raw land held for appreciation. Even if purchased with the idea that someday the owner may develop the property, if it is not developed for any reason, the property will not lose its classification as investment property.

If sold at a gain, the gain is a capital gain. If sold at a loss, the loss is a capital loss subject to the capital loss limitation rules.

Real estate held for investment qualifies for Section 1031 treatment when exchanged for other investment real estate or for real estate used in a trade or business.

## **Like-kind Property**

Like-kind is a federal tax term relating to the nature or character of the real estate in the hands of the Exchange Party rather than to its grade or quality. The fact that the real estate is improved or unimproved is immaterial, for that relates only to the grade or quality of the property and not to its kind or class.

Qualified real estate located in the 50 United States is of like-kind when exchanged for other qualified real estate located in the 50 United States and the U.S. Virgin Islands. The definition of "50 United States" means exactly that; any foreign real estate included in the exchange will be treated as boot paid or received.

## **Excluded Assets**

Section 1031 specifically excludes the following assets from nontaxable treatment: property held primarily for sale (inventory), stocks, bonds, notes, accounts receivable, certificates of trust or beneficial interest, securities, or evidences of indebtedness. It does not matter if the excluded property items are related to real estate; they always are excluded from Section 1031 treatment. For example, a note secured by real property can never qualify.

## **Partnership Interests**

Interest in a partnership does not qualify under Section 1031 if traded for an interest in another partnership. However, a partnership as an entity can exchange real estate it owns for other like-kind real estate.

## **Transfer Between Spouses**

There are no income tax consequences from entering into financial transactions between spouses. In addition, most transfers incident to a divorce are tax free. However, transactions with a former spouse are normally subject to tax unless they qualify for non-recognition under the provisions of Section 1031.

## **Sale/Lease Back as an Exchange**

A lessee's interest in a lease for real property with a term of 30 years or longer is considered property of like-kind for purposes of Section 1031 and therefore may qualify for Section 1031 treatment. The receipt of prepaid lease payments, whether for a 30-year lease or not, are taxed as ordinary income and will not qualify for tax-free exchange treatment.

## **Personal Property Business Assets**

Personal property assets used in a trade or business may be exchanged for like-kind assets of another business and qualify under Section 1031. Like-kind requirements and classifications for personal property are much more stringent than for real property.

## **Vacation Homes**

A vacation home or second home not held as a rental is classified as real estate held for personal use and does not qualify for Section 1031 treatment. However, under the rules of Section 280, a dwelling unit held for both personal use and rental purposes must take a use test each tax year to determine its tax classification for that tax year.

A property is treated as rental property if:

1. The Exchange Party owned the property for at least 24 months immediately prior to the exchange, and

2. In each of the 2- to 12-month periods immediately prior to the exchange:
  - a. The property is rented at a fair rental for more than 14 days during the tax year, and
  - b. The Exchange Party's personal use of such property does not exceed the greater of 14 days or 10% of the rental days during each 12-month period.

In such instance, the property may qualify for Section 1031 treatment.

A property is treated as real estate held primarily for personal use and treated as an asset not held for profit if the Exchange Party's personal use of such property is more than 14 days or 10% of the total rental days during each 12-month period, and the unit is rented at a fair rental for less than 14 days during such 12-month period.

## TIME RESTRICTIONS AND RULES

Under the Regulations, two time limitation periods have been imposed on Deferred Exchanges. One limitation requires Replacement Property to be identified within a certain time period. The other requires Replacement Property to be received by the Exchange Party within a certain time period. To successfully qualify for Section 1031 treatment, the exchange must satisfy both tests.

In a Deferred Exchange, any Replacement Property received will be treated as property that is not like-kind to the Relinquished Property if:

- the Replacement Property is not "identified" before the end of the "identification period", or
- the identified Replacement Property is not received before the end of the "exchange period".

The identification period begins on the date the Exchange Party transfers the Relinquished Property and ends 45 days thereafter.

The exchange period begins on the date the Exchange Party transfers the Relinquished Property and ends on the earlier of 180 days thereafter or on the due date (including extensions) for the Exchange Party's tax return for the taxable year in which the transfer of the Relinquished Property occurs.

Sometimes in a Deferred Exchange, more than one Relinquished Property is transferred and the transfers are on different dates. If this occurs, the identification period and the exchange period are measured from the earliest date on which any of the properties is transferred.

### Replacement Property

Replacement Property must meet exacting identification and receipt requirements. There are limitations on how many Replacement Properties may be identified in the same Deferred Exchange, no matter how many Relinquished Properties are transferred.

The penalty for violating the permitted maximum is severe. The Exchange Party is treated as not having identified any property within the identification period and the entire exchange will fail.

More than one Replacement Property may be identified, subject to three rules. The Exchange Party must satisfy only one of these rules (not all of them).

- **The 3-Property Rule:** The maximum number of Replacement Properties an Exchange Party may identify is three properties without regard to fair market values of the properties. This Rule is the most commonly used.

- **The 200% Rule:** An Exchange Party may identify any number of Replacement Properties as long as their total combined fair market value does not exceed 200% of the total combined fair market value of all Relinquished Properties. Fair market value of Replacement Properties may be calculated as of the end of the identification period and as of the date transferred. If, as of the end of the identification period, the Exchange Party has identified more properties as Replacement Properties than permitted, it is treated as if no Replacement Property has been identified.
- **The 95% Rule:** An Exchange Party may identify any number of Replacement Properties if, during the Exchange Period, he actually received the identified Replacement Properties having a total combined fair market value equal to or more than 95% of the total combined fair market value of all identified Replacement Properties.

### **Special Exception**

Any Replacement Property received before the end of the identification period is treated as being properly identified under the Identification Rules.

### **Trade Even or Up in Value**

The Replacement Property the Exchange Party wishes to acquire needs to have a value equal to or greater than the adjusted sales price of the Relinquished Property. All sale proceeds from the Relinquished Property need to be invested in the Replacement Property.

The Exchange Party must take the subject of mortgage debt relief into account since the IRS treats net mortgage relief the same as cash boot received. Simple arithmetic dictates that in order to trade up from the sale of mortgaged Relinquished Property, the Exchange Party must pay an additional amount in the form of cash or new mortgage debt to meet the purchase price of the Replacement Property.

It is not necessary for the amount of the new mortgage debt (if any) in the purchase of the Replacement Property to be the same as the amount of existing mortgage debt relief.

Gain will be taxable only to the extent that these goals are partially achieved. If all the goals are accomplished, the entire gain will be deferred.

### **Incidental Property**

For purposes of completing a proper identification within the 45-day identification period, it should be noted that property that is incidental to real estate property, such as furniture, laundry machines, appliances, pumps, etc., is not treated as separate property from the real estate property if:

1. In standard commercial transactions the property is typically transferred together with the real estate property, and
2. The aggregate market value of the incidental property does not exceed 15% of the aggregate market value of the real estate property.

For example, the Replacement Property is an apartment house complex worth \$1,000,000. The furniture, laundry machines, and other items in the apartment complex should not exceed \$150,000 in value, which is 15% of the complex' fair market value. For purposes of identification, the entire apartment complex, including furniture, laundry machines, etc., will be treated as one property.

### **Identification of Replacement Property**

The Replacement Property is considered identified before the end of the identification period only if the following requirements are satisfied:

1. It is designated as Replacement Property in a written document signed by the Exchange Party. This document must be hand delivered, mailed, faxed, or otherwise sent before the end of the identification period to a person (other than the Exchange Party or a related party) involved in the exchange.
2. It is unambiguously described in the written document or agreement. Real estate is unambiguously described if it is described by its legal description or street address.

In all events, any Replacement Property the Exchange Party receives before the end of the identification period will be treated as identified before the end of the identification period.

### **Revocation of Replacement Properties**

The Identification of Replacement Properties can be revoked at any time within the 45-day identification period. This revocation must be in writing and should include a rescission of a purchase and sale agreement, if one was written.

### **Receipt of Replacement Property**

Replacement Property is treated as received before the end of the Exchange Period if:

1. The Exchange Party actually acquired the Replacement Property (closed the transaction) prior to the end of the Exchange Period (180 days, or the due date of the taxpayers tax return, whichever is earlier), and
2. The Replacement Property acquired is substantially the same as identified during the 45-day identification period.

## **New Construction Replacement Property**

One of the more interesting stipulations is the regulation that permits the exchange for real property that has not yet been built. A transfer will qualify for Section 1031 treatment if the new construction is identified within the 45-day period and received within the 180-day exchange period. Careful identification of this property is needed and should include the legal description of the underlying ground and as much other description as possible for the improvements to be constructed. The new construction must be completed and received in substantially the same form as described in the identification documents.

An Exchange Party cannot exchange for services. Partially completed real property can be received in a like-kind exchange if properly identified.

## **Information Reporting to the Internal Revenue Service**

The taxpayer will need to provide his tax advisor with copies of the following documents:

1. Sales Contract, exchange documents, closing statement, and 1099 from the sale of the Relinquished Property,
2. Purchase Contract, exchange documents, and closing statement from the purchase of the Replacement Property, and
3. Form 1099 received from Unlimited Exchange for interest earned on the exchange proceeds while held by Unlimited Exchange, in order that the 1031 exchange transaction can be properly reported to the IRS. This will require the filing of a Form 8824.

For the sale of depreciable rental or business property, the taxpayer also will need to file a Form 4797, "Sale of Business Property". For the sale of non-depreciable investment property, the taxpayer will need to file a Form 1041, Schedule D, "Capital Gains and Losses". The basic rule is that closing costs reduce realized gain on the Relinquished Property, reduce boot received, and are added to the basis of the Replacement Property.

Remember, if the taxpayer sells the Relinquished Property after October 18 of a particular year, the taxpayer will have fewer than 180 days within which to complete the exchange. The actual deadline is the date the taxpayer's tax return is due, typically April 15 of the year following the sale of the Relinquished Property. The taxpayer must complete and file an extension to file his tax return in order to obtain a full 180-day exchange period.

Be aware that the IRS generally has three years within which to audit a tax return. However, the statute of limitations is extended if a taxpayer fails to report more than 25% of gross income. The tax savings from a Deferred Exchange often activates this extension.