1031 Exchange Frequently Asked Questions

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What is a 1031 exchange?

A 1031 exchange is a tax-free way to "exchange" one investment property for another, by selling one property and purchasing another property. Exchanges allow property investors to indefinitely defer capital gains until a later taxable event, such as the sale of a property without an exchange. The IRS Section 1031 sets specific requirements for this exchange to be tax-free. A 1031 exchange is also known as a tax-free exchange, tax-deferred exchange, delayed exchange, like-kind exchange, nontaxable exchange, real estate exchange, real property exchange or Starker exchange.

I just sold my commercial property. Now what?

If you realized profits from the sale of that property, prepare to pay capital gains taxes, which could be as much as 47% of your profit.

However, you can roll the entire proceeds from your sale into the purchase of another property. RealNet will help you find a new place for your capital to preserve your full investment.

How are capital gains taxes calculated?

Tax is calculated on the taxable gain. To determine your gain, identify your original purchase price, deduct any depreciation (which has been previously reported), then add the value of any improvements that have been made to the property. The resulting figure will reflect your cost or "tax basis." Calculate your gain by subtracting the cost basis from the net sales price.

Who should consider a 1031 exchange?

When the sale of an investment property provides a net gain, the seller should consider a 1031 exchange. Net gains can be realized from property that was depreciated for tax purposes, or has appreciated in fair market value.

1031 exchanges help investors diversify their real estate portfolios by moving from smaller properties to larger ones, exchanging one property for many, or the reverse scenario. For example, you might choose to

sell an apartment complex in which you have $750,000 equity and reinvest $250,000 in each of three larger assets through a tenant-in-common ownership structure. This would diversify your geographic range and property types, as well as eliminating the hours you spent managing the apartment complex.

What are the requirements?

Section 1031 of the Internal Revenue Code allows a real property owner who sells his or her own property to reinvest the proceeds of the sale in a like-kind property. By following the rules of the tax code, which requires owners to identify a replacement property within 45 days and close the transaction within 180 days of the relinquished property's closing date, the owner is exempt from capital gains tax.

Below is a paraphrase of the 1031 Exchange rules. See *http://www.irs.gov/faqs/faq-kw2.html* for more details:

- The real property you sell and the real property you buy must both be held for productive use in a trade or business or for investment purposes, and must be like-kind.
- The proceeds from the sale must go through the hands of a qualified intermediary and not through your hands or the hands of one of your agents, or else all proceeds will become taxable.
- All the cash proceeds from the original sale must be reinvested in the replacement property; any cash proceeds that you retain will be taxable.
- The replacement property must be subject to an equal or greater amount of debt than the relinquished property, or the buyer will either have to pay taxes on the amount of decrease or put in additional cash funds to offset the lower level of debt on the replacement property.

Can I initiate a 1031 exchange after the close of escrow on the relinquished property?

No. Once you have closed escrow and the funds have been disbursed, it is presumed you have constructive receipt of the funds — even if you haven't cashed the check. This is why you need a qualified intermediary to control the funds between the sale of the relinquished property and the purchase of a new property.

What are the rules for choosing a replacement property?

You may identify three properties as possible replacements for your relinquished property. More than 95 percent of exchange use this type of rule. Alternately, you may identify any number of properties as possible replacements, provided that the aggregate value of these properties does not exceed 200% of the value of your relinquished property. A third option is to identify any amount of properties as possible replacements, provided you purchase at least 95% of the aggregate value of all properties identified.

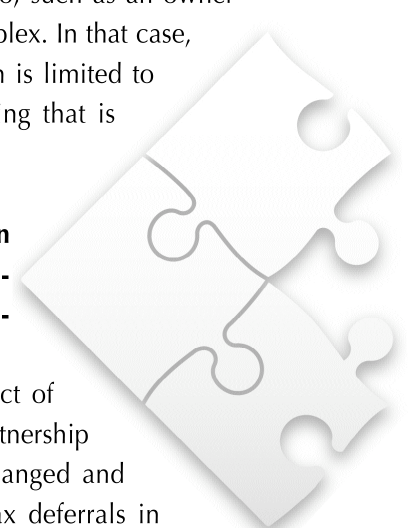
You may exchange any real property for any real property within the United States or its possessions, provided the properties are held "for productive use in trade or business or for investment purposes." Examples of these properties are commercial office buildings, retail, industrial, rental homes and duplexes, apartments, condominiums and raw land. RealNet Investments LLC provides commercial office, retail and industrial investment options.

Does my home qualify as a like-kind property?

Generally, no. Your primary residence is not eligible for exchange. However, an exchange is still possible in a mixed-property scenario, such as an owner-occupied apartment complex. In that case, the exchangeable portion is limited to the portion of the building that is leased out.

Does the property I own in partnership with another person qualify as like-kind?

No. The Tax Reform Act of 1984 specifies that partnership interests cannot be exchanged and do not qualify for the tax deferrals in



Section 1031. These rules do not distinguish between limited and general partnership interests. However, if Mr. Smith buys out his partner Ms. Jones, making Mr. Smith the sole owner of the property, he would be allowed to make a 1031 exchange of his interest in that property for another.

How do I identify a property?

The Identification Period is the first 45 days of the 180-day exchange period. During this time, the exchangor must identify target properties using one of the three methods explained above. The property identification must be made in writing, signed and delivered to the exchange facilitator or other qualified intermediary via fax, postmarked mail or dated courier service. The facilitator must receive the identification papers within 45 days or else the exchange will fail.

Tenant in common ownership has become increasingly popular among investors who wish to identify a TIC property in case another identified property falls through. As a TIC sponsor, RealNet also takes the hassle out of the identification process by providing an extensive, organized due diligence package complete with plans, photographs, financial and environmental assessments, appraisals, leases and lease abstracts, tax and tenant information.

What is the timeline for the exchange?

The investor has 45 days from the close of escrow of the relinquished property to identify potential replacement properties, and 180 days from the close of escrow to complete the acquisition of the replacement property or properties. These are firm requirements, based on calendar days, and are not adjusted even if the final day falls on a Sunday or holiday. If the close of escrow falls after Oct. 15, the investor must file a tax extension to use the full 180-day period.

Can I get an extension or waiver?

No. The IRS is very strict on these guidelines and no deviation is allowed for a successful exchange. Although only 3% to 5% of exchanges are audited, those exchanges that fail on audit are typically due to discrepancies in identification.

What kind of exchanges are available?

- The Delayed Exchange is most commonly used, and is also known as a Starker exchange. The name refers to an exchangor who was challenged by the IRS on the delayed exchange. A code change in 1984 formally recognized the delayed exchange as an acceptable practice under §1031. In the delayed exchange, you have 45 days from the close of escrow to identify replacement properties, and a further 135 days to complete the purchase of the replacement asset, for a maximum of 180 between the sale of your asset and the purchase of your replacement property. RealNet specializes in the delayed exchange.
- The Simultaneous Exchange happens when you have identified the property or properties you wish to exchange prior to the close of escrow for your relinquished property. The two properties are exchanged concurrently, but there are some risks and timing complications, so you are urged to work with a qualified intermediary to ensure the process is completed smoothly. The qualified intermediary helps the investor avoid the possibility that the IRS disallows the exchange under the rule that prohibits the investor from having unrestricted control of the proceeds from the property sold.
- A Reverse Exchange simply reverses the process of a delayed exchange, so an investor purchases a replacement property prior to completing the sale of the relinquished property.
- There are also exchanges such as the Improvement Exchange, in which you count improvements to a property in the final total value of the replacement property.

Do 1031 exchange rules apply to more than real estate?

Yes. Personal property held for productive use in investment, business or trade may also be exchanged for like-kind or like-class personal property, but the rules are more restrictive. Aircraft and business exchanges allow certain businesses and personal

property items to be exchanged for others within a narrow asset class. While improved real estate may be exchanged for unimproved real estate, a car may not be exchanged for a truck because it is not considered like-class property. Please consult your tax advisor for more details on personal property exchanges.

What is the history of the 1031 exchange?

Income taxes were first imposed in 1918, and gain or loss recognition was required on the disposition of all property. Tax-deferred exchanges were introduced in 1921 to allow investment property owners to defer payment of capital gains taxes associated with the sale of these properties. Through a series of amendments, the IRS has codified what we now know as the tax-deferred or 1031 exchange.

In the March, 2002 Revenue Procedure 2002-22 document, the IRS finally gave its seal of approval to tenant-in-common ownership as a legitimate part of a 1031 exchange. The Revenue Procedure outlined specific constraints on TIC ownership. For more details on TIC ownership, please see our Tenant In Common Frequently Asked Questions.

Glossary

Adjusted Basis — The original basis plus improvement costs, minus the depreciation of the property.

Boot — Any assets received from an exchange that are not like-kind. Most commonly, these are a "cash boot" or "mortgage boot." All boots are taxable.

Cash Boot — Any cash an exchangor receives upon final closing of the relinquished property is taxed.

Constructive Receipt — A term that refers to the exchangor having unrestricted control of the equity from the property sold. Constructive receipt invalidates an exchange.

Equity — The proceeds from the sale of a property.

Exchange Period — The 180-day period an investor has to complete the exchange, between closing escrow on the relinquished property and closing escrow on the replacement property. A period longer than 180 days between these events invalidates the exchange.

Exchangor — The investment property owner who sells the property and acquires another under §1031 rules.

Fair Market Value — The likely selling price as defined by the market at a specific point in time.

Identification Period — The time period that begins immediately upon the close of escrow of the relinquished property. During this 45-day window, the exchangor must identify the replacement property.

Like-kind Property — The properties involved in an exchange must be similar in nature and characteristics. They might include raw land, apartments, duplexes, retail, office or industrial properties or rental homes not occupied by the exchangor.

Original Basis — The purchase price of a property, which is used to calculate capital gains or losses for tax purposes.

Personal Property — Any property belonging to an exchangor that is not real estate-related.

Phase I, or Down-Leg — The process in which the relinquished property is sold and all the paperwork completed.

Phase II, or Up-Leg — The process in which the replacement property is purchased and the paperwork completed.

Qualified Intermediary — A third party that facilitates the exchange, sometimes referred to as the facilitator or accommodator. The qualified intermediary or another third party must control the exchangor's funds during the exchange period.

Relinquished Property — The property an investor will sell when making an exchange

Replacement Property — The property an investor will buy when making an exchange.

Starker Exchange — Another term for a §1031 delayed exchange.

Tenant in Common — An ownership structure that allows multiple people to own a fractional, undivided interest in a specific property. See our TIC - FAQ.

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