

1031 Tax Exchange

Jerry Babin, RE/MAX Southern Realty
34894 Emerald Coast Pkwy
Destin, FL 32541

(850)-837-1880 x226
Toll Free: (877) 846-9228
Fax: (850) 837-8724
E-mail: jerry@jerrybabin.com

<http://www.jerrybabin.com>



IRC Section 1031

Often investors do not realize taxation on a personal residence is far different than taxation on income or investment property. The Taxpayer Relief Act of 1997 changed Internal Revenue code treatment for the sale of a personal residence to allow a single taxpayer a \$250,000 exclusion from capital gain. Married couples receive a \$500,000 exclusion. The taxpayer must have resided in the property two of the last five years. This exemption may be used once every two years.

If an investor sells property they pay tax. However, property that qualifies for preferential tax treatment under Internal Revenue code Section 1031 is treated quite differently. IRC Section 1031 States: **“No gain or loss shall be recognized if property held for productive use in a trade or business or for investment purposes is exchanged solely for property of a like-kind.”**

Therefore, an investor using IRC Section 1031 can exchange raw land for a rental home, an apartment complex for a shopping center or rental houses for an office building. The use of the property is the factor in determining the tax treatment.

The code has remained substantially unchanged for the past 50 years and was clarified with Treasury Regulations in 1991. The Regulations redefined the “Starker” or delayed exchange, including the 45-day identification requirements for replacement property. These Regulations also encourage the use of a Qualified Intermediary, deeming them a “safe harbor.” A “safe harbor” is a term that defines acceptable guidelines so a transaction will be regarded defensible.



The Taxpayer Relief Act of 1997, The “20% Myth”

The law aimed at balancing the federal budget lowered the capital gains rate. However, the capital gains rate changes are not as straight forward as they seem. Many investors mistakenly believe their long term capital gains will be taxed at 20%. **While gain from appreciation is taxed at 20%, gain from depreciation is taxed at 25%.**

Example:

A Property purchased for \$75,000 is depreciated and later sold for \$150,000. At the time of the sale the adjusted basis is \$25,000 creating gain of \$125,000. Is the capital gain 20%? No! Only gain from appreciation is 20% (i.e. the \$75,000 increase will be taxed at 20%). ***The remaining gain from depreciation of \$50,000 will be taxed at 25%.***

Additionally, most states will apply state taxes over and above the Federal tax rates.

HOLDING PERIODS AND INDIVIDUAL TAX RATES

Holding Period	Sale JANUARY 1, 1998 and later
12 months or less	Taxed as ordinary income
More than 12 months	Upper Bracket 20% Lower Bracket 10%

- If a taxpayer in the lower tax bracket realizes a large capital gain they may be forced to realize part of their gain at the higher 20% rate.
- Corporate brackets of 15%-35% remain the same.



Exchange... Don't Sell

Every Dollar saved in taxes will allow an investor to purchase 4-5 times as much real estate...

This is possible through the use of leverage. Leverage is a method of acquiring real estate worth many times the value of the initial investment. Tax deferral increases leverage. To understand the power of leverage, consider that ten percent appreciation is converted to a 50% profit with a 20% down payment. The following example shows the value of leverage by illustrating the benefit of exchanging versus selling.

Assume an investor sells a fully depreciated property and the capital gain is \$200,000. This amount is subject to taxation. Federal tax brackets can range up to 20% for capital gain from depreciation. State taxes can be as high as 10%. Assuming a total tax bracket of approximately 40%, the capital gains tax would be:

$$\text{\$200,000 times 35\%} = \text{\$70,000}$$

If the investor sold property with a gain of \$200,000, they would pay taxes of \$70,000 and have only \$130,000 left to reinvest. On the other hand, the investor who exchanges pays no capital gains tax, leaving the entire \$200,000 to reinvest.

	Sale	Exchange
Proceeds	\$200,000	\$200,000
Tax Owed	-70,000	0
Cash to Reinvest	\$130,000	\$200,000

If each investor purchases a building with a 20% down payment, using leverage each could buy property worth:

Value	\$650,000	\$1,000,000
-------	------------------	--------------------

In a single transaction, the investor who exchanged has \$350,000 more property than the investor who sold property.



Qualified Intermediary

SSI must function as a principal in the transaction. In fact, the 1991 Treasury Regulations specify which parties are disqualified from functioning as an Intermediary. With a few exceptions, the following are considered disqualified parties:

- (1) A close family member or a controlled corporation, partnership, or trust.
- (2) Entities considered agents of the investor such as their: employee, closing/escrow officer, Attorney or Accountant, Investment Banker or Broker, Real Estate Agent or Broker.



Benefits of Exchanging

Prior to 1979, trading properties was at best complicated. Completing a tax deferred exchange meant properties had to be “swapped” simultaneously. Unfortunately, this made exchanging cumbersome and risky, if not impossible.

The 1979 Starker decision in the U.S. 9th Circuit Court of Appeals enabled the non-simultaneous or “delayed” exchange to qualify for tax deferral. This gave investors the time necessary to find desirable replacement properties by using an Intermediary.

Treasury Regulations effective June 10, 1991 validated the delayed exchange and simplified the exchange process. These Regulations which included the use of Qualified Intermediaries, were welcomed by real estate investors who were previously uncertain of the viability of 1031 transactions.

Many investors have held property for years because a sale translated into paying substantial taxes on their capital gain. Recent changes still do not offset the benefits of exchanging. Typically, as an investor’s needs change over the years, the type of investment property they want changes. Relocation, estate building, retirement, desire to increase cash flow, to reduce management responsibilities, all affect the type of property investors want to own. Under IRC Section 1031, investors now have the alternative of moving their investments (and equities) into more desirable or profitable properties.

The true power of exchanging is the ability to meet investment objectives without losing equity to taxation.



“Like-Kind” Property

Investors often mistakenly believe they must acquire a property exactly like their relinquished property. They are surprised to learn a wide variety of properties can be considered “like-kind.

“Like-kind” does not refer to the type of property. Instead, it addresses the intended use of the property. Provided the property is initially acquired and held for either business or investment purposes, it can qualify as a suitable replacement property under IRC Section 1031.

For example, any of the following can be considered “like-kind” property exchanges: a duplex for a fourplex, bare land for improved property, a rental house for a retail center or an apartment building for an office building. Investors do not have to exchange for exactly the same type of property as relinquished.

The tax code also lists items that are not considered “like-kind” and are expressly excluded from non-recognition. These include: stock in trade or other property held primarily for sale; stocks, bonds, or notes; other securities or evidences of indebtedness; interests in a partnership; certificates of trust or beneficial interest; choses in action. In addition, the Code was amended in 1989 rendering property outside the United States non “like-kind”.



Exchange Variations

EXCHANGING CAN RANGE ANYWHERE FROM A SIMPLE SWAP OF TWO PROPERTIES TO A COMPLEX, MULTI-LEG, MULTI-PARTY TRANSACTION INVOLVING CONSTRUCTION AND/OR REVERSE EXCHANGES.

Simultaneous Exchanges

Prior to the 1979 Starker decision, most exchanges were limited to the simultaneous format. In a simultaneous exchange, both properties close the same day. Since 1991, the only “safe harbor” for a simultaneous exchange is the use of a Qualified Intermediary.

Delayed Exchanges

The Starker decision marked the advent of delayed exchanging. In the delayed exchange, “like-kind” property must be designated within 45 days of the sale closing. The replacement property must be closed by the 180th day. Once the replacement property has been located, the Intermediary purchases it and immediately trades the property to the exchanger.

Construction (Improvement) Exchanges

The construction exchange (sometimes termed improvement exchange) is an exchange where the Intermediary retains ownership to the replacement property and improves it. Once construction is complete, the Intermediary trades the property to the exchanger.

Reverse Exchanges

Ideally, an investor will be able to sell the relinquished property first and then close on the replacement property. Circumstances sometimes make it necessary to acquire the replacement property before closing on the relinquished property. This can be accomplished through a reverse exchange.

Multi-Property and Multi-Party Exchanges

An investor can trade out of one property into several, or consolidate from smaller properties into one larger property. Two or more investors owning a property together can trade into separate properties.



The Delayed Exchange

In a delayed exchange, the replacement property must be designated within 45 days of closing escrow on the relinquished property and close within a total of 180 days.

Do You Know

What is the difference between a sale and an exchange?

A sale is an exchange of real property for cash. A sale and repurchase of like-kind property following the Internal Revenue guidelines is an exchange; a “non-taxable” sale.

What provisions are required in a Purchase and Sale Agreement to enter into an exchange?

A Purchase and Sale Agreement should contain language establishing the exchanger’s intent and notifying the buyer of the exchange. Examples are:

When Selling:

“It is the intent of the Seller to perform an IRC Section 1031 tax deferred exchange by trading the property herein with a Qualified Intermediary. Buyer agrees to execute an Assignment Agreement at the request of Seller at no additional cost or liability to Buyer.”

When Buying:

“It is the intent of the Buyer to perform an IRC Section 1031 tax deferred exchange by trading the property herein with a Qualified Intermediary. Seller agrees to execute an Assignment Agreement at the request of Buyer at no additional cost or liability to Seller.”

Can an investor trade from several small properties into one large one?

Yes. An investor can also trade out of one large property into several smaller ones. When selecting more than one replacement property, investors must adhere to the Treasury guidelines regarding property identification.

Can an investor take some of the cash and exchange the remainder?

Yes. Any cash received can be subject to capital gains tax. If done properly, this won’t affect partial deferral.



Can an investor receive cash from refinancing their property?

Refinancing is not a taxable event if done correctly.

Can an investor carry back a note on their property?

Yes. There are several different ways to handle a note in an exchange. Tax or legal counsel should always be consulted whenever an investor carries a note.

Can a partnership, L.L.C., corporation or trust perform an exchange?

Yes. These entities can all exchange property they own for different property.

Can an investor trade out of a partnership?

Limited partnership interests are considered personal property and therefore do not qualify as “like-kind”. If one partner wants to exchange separately they should consult their counsel to avoid triggering a taxable event.

Can assets other than real estate be exchanged?

Yes. Taxes can be deferred using IRC Section 1031 on most personal property including but not limited to businesses, planes, boats, trucks, and equipment.

Can an investor cancel the exchange whenever they want?

The exchange agreement allows cancellation under certain circumstances however limits must be set. Having the right to cancel without limits could be construed as control of cash, which would disallow the exchange.

Can an investor build or improve a replacement property?

Yes. The regulations describe this as a Construction or Improvement exchange. The Intermediary will keep the investor within the safe harbor guidelines.



Exchange Process

Starting an exchange is a simple procedure.

The exchanger simply enters into the Purchase and Sale Agreement for the relinquished property. There is little difference between the familiar sale transaction and an exchange performed a Qualified Intermediary.

Step #1 Relinquished Property

1. Contact a Qualified Intermediary upon deciding to perform an exchange. The Intermediary works with all parties, including the real estate agent, attorney, and accountant.
2. The Intermediary will ask for the name and address of the exchanger, the real estate agent, and the escrow holder/closing attorney. This is all the intermediary needs to prepare the documentation. Upon closing, ownership of the exchange property will transfer to the intermediary, and then to the buyer. A Qualified Intermediary will be available to assist everyone involved with answers to any questions that may arise.

Step #2 Identification

Replacement property **must be identified within 45 days from closing** the relinquished property. The Intermediary provides the necessary documentation to comply with the Treasury guidelines regarding proper identification.

Step #3 Replacement Property

The acquisition of the replacement property must be completed within 180 days of closing the relinquished property. After locating suitable replacement property, the exchanger should enter into an agreement to purchase and immediately notify a Qualified Intermediary.

Instructions to complete the exchange will be delivered to the closing officer and all parties involved for review and signature. The exchange is completed when the property is purchased by a Qualified Intermediary and then transferred to the exchanger.



“Taxes are paid on capital gain, not equity or profit”

It is possible to have little or no equity and still owe tax. Capital gain is arrived at by subtracting the adjusted basis from the adjusted sale price. The adjusted sale price is the gross sale price minus standard transaction costs. To arrive at the adjusted basis, first establish cost basis (usually the original purchase price). Nest, add to this figure all improvements made to the property, which were not expensed. Then, subtract all depreciation taken over the period of ownership.

To determine the estimated capital gain, subtract the adjusted basis from the sale price. Next, subtract the transaction costs (commissions, fees, ect.) to determine the capital gain. Finally, multiply the capital gain by your combined tax rate (Federal and State) to determine your estimated capital gains tax. Remember there are two different rates (see page two).

Original Purchase Price	_____
Plus Capital Improvements	_____
Equals Adjusted Basis	_____
Current Sales Price	_____
Minus Adjusted Costs	_____
Minus Transaction Costs	_____
Equals Capital Gain	_____
Times your Tax Rate For appreciation	_____
Times Your Tax Rate For depreciation	_____
Add state taxes	_____
Equals Capital Gains tax*	_____



The Role of Real Estate Exchange Corporation As Qualified Intermediary

- Provides the required exchange agreement for review and approval by you and your tax advisor.
- Accepts assignment of exchange contracts.
- Provides notification of the assignment to all parties.
- Furnishes instructions to the closing agent.
- Establishes a qualified escrow account.
- Receives the 45-day identification notice.
- Delivers escrow funds for settlement.
- Arranges for direct deeding of properties.
- Gives a final accounting of escrow funds and interest earned.

Disclosure

Jerry Babin – Realtor with RE/MAX Southern Realty cannot advise you concerning the specific tax consequences or advisability of a deferred exchange for tax planning purposes. You will be required to seek the counsel of your accountant or attorney. If we can answer any of your general questions, or those of your representatives, please do not hesitate to contact us.

