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# Introduction to 1031 Exchanges



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# Course Objectives

- Gain an understanding of the mechanics of a 1031 Exchange
- Identify the steps and time restrictions of a 1031 Exchange
- Gain an understanding of the federal rules and requirements in a 1031 Exchange
- Be able to identify other types of exchanges

# Taxation 101

Generally, all income is taxable, unless specifically exempted by law.

Even illegal income, such as stolen or embezzled funds, must be reported on Form 1040.



# IRC § 1031 (a)(1)

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

**Note that Section 1031 provides for deferral of taxes, not complete elimination.**

# Value of 1031 Exchange

**A 1031 Exchange allows the property owner to potentially defer four levels of taxation:**

- Federal Capital Gain (15% to 20%)
- Tax on depreciation recapture (25%)
- State income taxes (up to 13.3%), if applicable
- Net Investment Income Tax (NIIT; 3.8%), if applicable

| SALE | | | EXCHANGE | |
|---|---|---|---|---|
| Sale Price | $900,000 | | Sale Price | $900,000 |
| Expenses | - $80,000 | | Expenses | - $80,000 |
| Est. Taxes | - $180,000 | | Est. Taxes | $0 |
| Net After Tax Proceeds | $640,000 | | Gross Proceeds (1031 = tax deferral) | $820,000 |

# Sale VS. Exchange

# Equal Or Greater Value



Replacement property(ies) must be of equal or greater value to exchange value of Relinquished Property



Exchange value determined by subtracting closing costs and broker’s commissions from Relinquished Property(ies) value



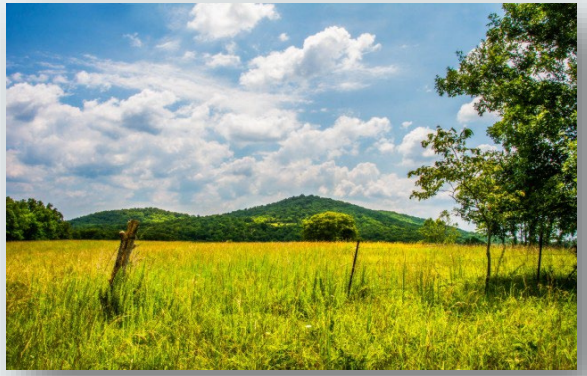
Exchange value not used in acquiring replacement is “boot” and taxable



Equity AND debt must be replaced

# What Is Considered “Like-kind” Property?

- Farmland
- Ranchland
- Hunting/Recreational Land
- Timberland
- Vacant Land
- Easements (Conservation and others)
- Mineral, oil, and gas rights
- Water and timber rights
- Wind and Solar farms
- Billboard sites
- Cell tower sites
- Other Property Types

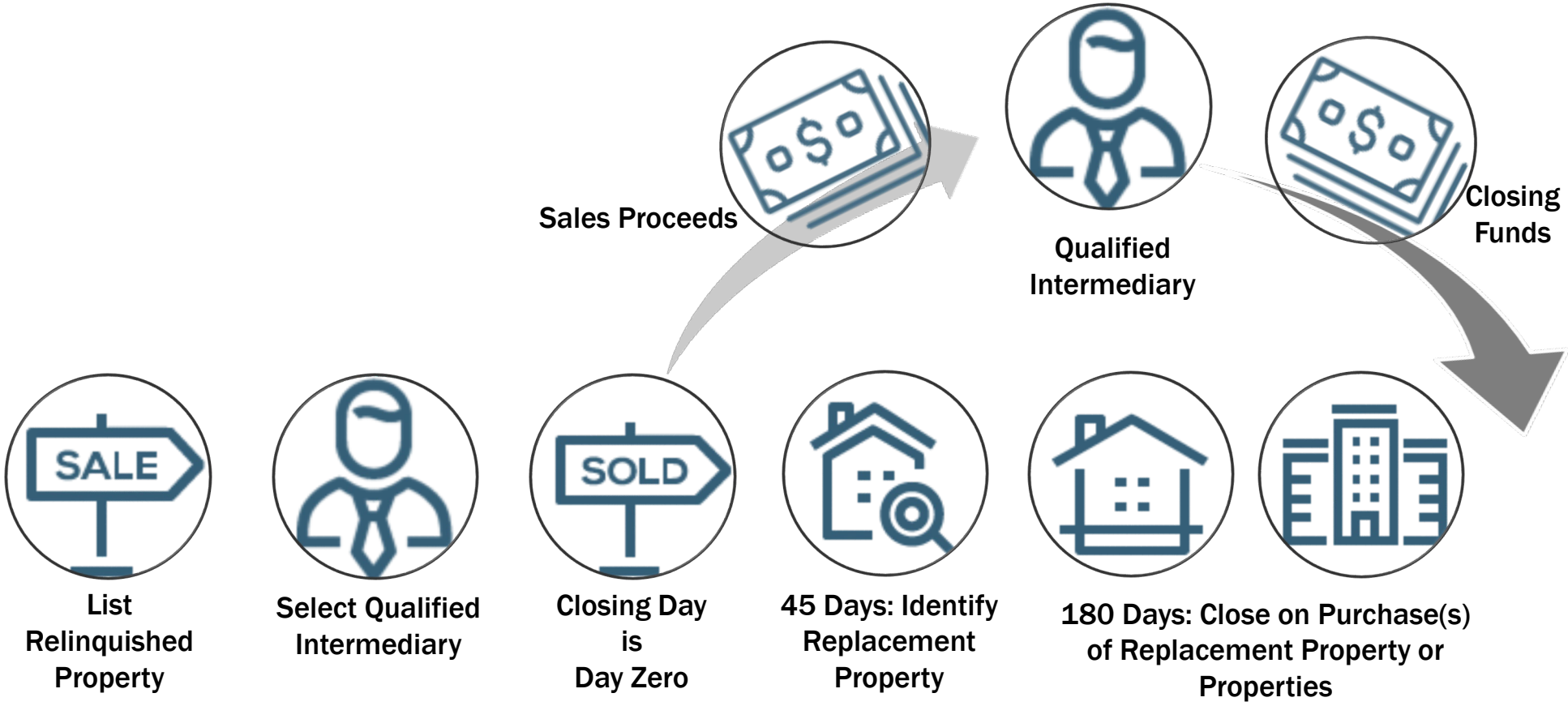








# The Process

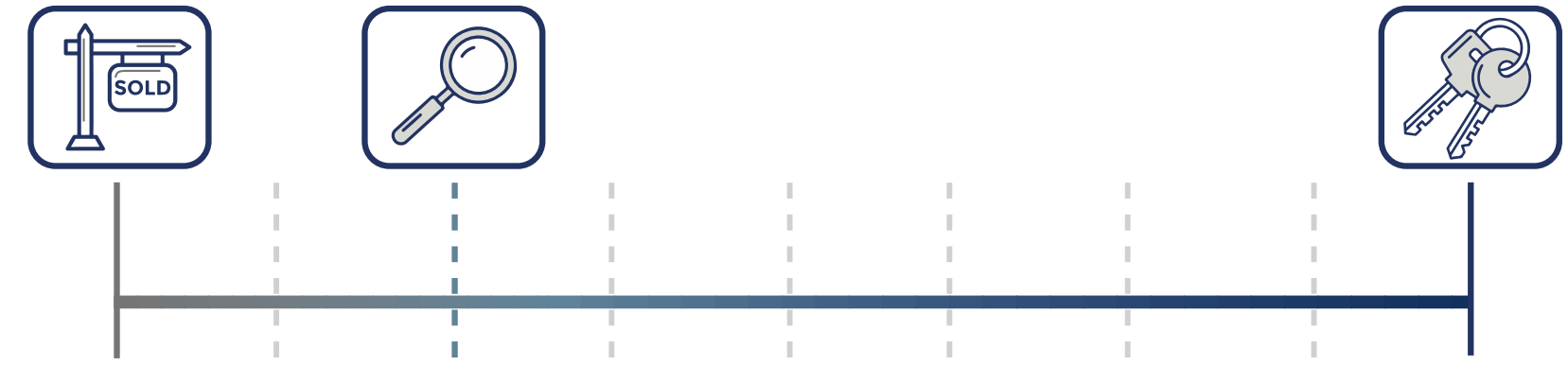

Sales Proceeds
Qualified Intermediary
Closing Funds
SALE
SOLD
List Relinquished Property
Select Qualified Intermediary
Closing Day is Day Zero
45 Days: Identify Replacement Property
180 Days: Close on Purchase(s) of Replacement Property or Properties

# 1031 Exchange Time Limits

**1984 Congress amended Section 1031**

- 45-day identification period
- 180-day exchange period runs concurrently
  - Or due date of tax return, whichever is earlier
- Calendar days, not business days
- No extensions
- Exchange starts on date of recording, or when burdens and benefits of ownership of Relinquished Property are transferred, whichever is first

# The Timeline




**Day 0**
Property is sold. 45-day identification period begins, and total 180-day timeline begins.

**Day 45**
Identification Period Ends.

The funds received from the sale of the old property remain with the Qualified Intermediary until the identified party is purchased, or 180 days is reached.

Three Rules when describing the specified property:
1. Unambiguously described
2. In writing
3. Submitted to the Qualified Intermediary

**Day 180**
Close

# Identification Requirements

**Signed, and in writing**

**Delivered**

- QI or seller of Replacement Property

**Unambiguously described**

- Legal description
- Street address
- Distinguishable name (e.g., Madison Square Garden)

**May be revoked or amended, with same formality as above**

# Identification Rules

**3**
Property Rule

Up to 3 properties of any value

**200%**
Rule

Any number of properties (greater than three) so long as the value does not exceed 200% of the Relinquished Properties

**95%**
Rule

Exchanger violated first two rules, therefore must acquire at least 95% of the value of all properties identified

# Section 1031 in a nutshell

**To obtain complete deferral of capital gains taxes, the Exchanger should:**

- Receive **nothing except like-kind** property
- Adhere to the 45-day and 180-day time limits
- Replacement property must be **equal or greater in value** to the Relinquished Property
- Must have **equal or greater equity** in the Replacement Property
- Must **replace the debt** (with cash or debt) on the Replacement Property
- Exchanger must avoid **constructive receipt** of exchange proceeds
    - Use a **Qualified Intermediary (QI)**

# Multiple Property Exchange

Exchanger can sell multiple properties, to consolidate into fewer properties

Exchanger can sell one property to diversify into many properties

*Identification period* – all Replacement Properties must be identified within 45 days of transfer of first Relinquished Property

*Exchange period* – all Replacement Properties must be acquired within 180 days of transfer of first Relinquished Property

# Same Taxpayer

**Taxpayer that owns Relinquished Property MUST be same tax entity that acquired Replacement Property**

- "Taxpayer" determined by tax return on which income/expenses/losses reported

**Owner/titleholder may not be "Taxpayer" for 1031 purposes**

- Living trusts
- Single-member LLCs
- Illinois land trusts

# Qualified Use

## Business or investment

- Holding bare land to appreciate = “held for investment”

## Holding period

- No specific length of time; matter of Exchanger intent

## No “dealer/flipper” property “held primarily for sale”

## Vacation homes or second homes do not qualify

## Changing title/liquidating entity before sale may disrupt qualified use

# Personal Use Property

*Exchanger's Intent*

**IRS Safe Harbor Rules For Personal Use of Rental Property**

- Replacement Property must be held for at least 2 years
- Exchanger must rent the Replacement Property for a minimum of 14 days in each of the 2 years; and
- Exchanger's personal use must not exceed 14 days or 10% of the number of days property is rented, whichever is greater.



# Fix and Flip Properties

Section 1031 does not apply to flipping.



# Allows Expenses Payable from Exchange Funds

## Examples of Allowable Expenses and Closing Costs:

- Real Estate Broker's Commissions
- Qualified Intermediary fees
- Recording or Filing Fees
- Attorney & Tax Advisor Fees Related to the Transaction
- Owner's Title Insurance Premiums
- Escrow or Settlement Agent Fees
- Finder Fees or Referral Fees- Documentary Transfer Taxes

# Types Of Exchanges

| FORWARD EXCHANGE | REVERSE EXCHANGE | IMPROVEMENT EXCHANGE |
| --- | --- | --- |
| Sell investment property and, within 180 days, complete the purchase of new investment | Purchase of new investment property occurs before sale of original investment property (must complete within 180 days) | Sell investment property, use accommodator to acquire and hold property while improvements are made. *Can be structured as forward or reverse* |

# Why Are 1031 Exchanges Important?

- Like-kind exchanges stimulate business growth
- Like-kind exchanges stimulate needed capital investment
- Like-kind exchanges help repurpose available real estate
- Like-kind exchanges create jobs
- Like-kind exchanges help family farmers
- Taxes are deferred, not eliminated

Visit www.1031buildsamerica.org for more information

# Questions?