1031 FAQs

Q. WHAT IS A 1031 EXCHANGE?

A. It is a method whereby a taxpayer can sell his/her property/properties and acquire other property/properties without currently paying tax on the capital gain. The tax is deferred, not eliminated, by effectuating a 1031 Exchange. A 1031 Exchange is sometimes also referred to as a "Starker Exchange", "Tax Free Exchange" or "Like-Kind Exchange".

CXS
CORPORATE EXCHANGE SERVICES

Q. WHAT IS "LIKE-KIND"?

A. "Like-Kind" refers to the nature or character of the property, NOT the grade or quality of the property. In a general sense, it refers to "substantially the same property." (e.g. real property for real property, a car for a car, etc....)

Q. WHAT TYPE OF REAL PROPERTY WILL QUALIFY FOR AN EXCHANGE?

A. The real property must be held for investment or for productive use in a trade or business. Therefore, this excludes the following types of property: homestead/ principal residence; "Dealer Property", which is property held primarily for sale; real property with a lease term of less than 30 years; partnership interests; stocks; bonds; notes or other beneficial interests. There is a "gray area" with regard to second or vacation homes as to whether they are qualifying property. Second/Vacation homes may qualify as investment property if personal use is minimal or if the home is rented. A property is apparently not "held for investment" within the meaning of Section 1031 if losses from a sale or exchange of the property cannot be deducted.

We recommend everyone contemplating an exchange to speak with his/her accountant or attorney with regard to his/her individual situation to determine whether the property is qualifying property.

Q. CAN I EXCHANGE ANY QUALIFYING REAL PROPERTY FOR ANY OTHER QUALIFYING REAL PROPERTY?

A. Yes. This includes exchanging improved real estate for unimproved, vacant real estate (gain will not be recognized except for that portion of the gain treated as Ordinary Income under the recapture rules of Sec. 1250) or business for investment property. Again, we always recommend that a taxpayer consult his or her tax advisor or attorney to determine whether the exchange would qualify.

Q. WHAT IS "RELINQUISHED" AND "REPLACEMENT" PROPERTY?

A. The "Relinquished" property is the property or properties which a taxpayer currently owns and is "selling" to a Purchaser. The "Replacement" property is the property or properties which the taxpayer will be acquiring.

Q. WHAT IF I RECEIVE CASH IN THE EXCHANGE, BECAUSE I HAVE TRADED FOR A PROPERTY OF LESSER VALUE?

A. This would be considered "boot." That cash would be considered taxable and would not receive the tax-deferred treatment. Capital gain is recognized on the lesser of the gain realized or the boot received. In addition to cash, "boot" also means: loan proceeds, notes, furniture, equipment and other personal property. In these cases, "boot" would be taxable and gain may be recognized to the fair market value of such "boot."

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Q. WHAT IF I HAVE A MORTGAGE ON MY PROPERTY?

A. This is considered in the "equation" of netting the fair market values of the properties to see if there is any "boot." If both the Relinquished and the Replacement properties have mortgages on them, the mortgages may be netted against one another. (i.e. liabilities assumed are offset against liabilities of which the taxpayer is relieved).

NOTE: Mortgage "boot" received (mortgage relief) can be offset by other "boot" given, but Mortgage "boot" given (new or assumed mortgage) cannot be offset by other "boot" received.

Q. CAN I REFINANCE IMMEDIATELY PRIOR TO OR AFTER THE EXCHANGE?

A. Refinancing to pull equity out of a property prior to or after completing a tax-deferred exchange can result in a taxable event under the "step transaction" doctrine. The IRS may believe that there was no independent business purpose for the refinance loan, the purpose of the refinance was merely to cash out of the equity of either the Relinquished Property or Replacement Property without paying the capital gains tax. There is mixed case law history on this issue.

Therefore, a Taxpayer should do several things to avoid the refinance being construed as a "step transaction" and to decrease the likelihood that the IRS will set the exchange aside:

1) The loan should not appear to be solely for the purposes of pulling out equity;

2) As a general rule, the refinance should be separated from the exchange sale or purchase by a least six months;

3) If the refinance cannot be completed by six months prior to the sale, it should be completed prior to listing the Relinquished Property for sale;

4) The refinance and sale or purchase should be documented as separate transactions to avoid any interdependence;

5) The refinance should be commercially reasonable and reflect an independent business purpose separate from the exchange.

Q. WHAT ABOUT A BROKER'S COMMISSION?

A. Brokerage commission paid from the cash boot may be deducted when determining the amount of gain that is recognized. The amount of commission is also added in determining the basis of the Replacement property.

Q. IS THERE WORDING THAT SHOULD BE PUT ON THE PURCHASE AGREEMENT FOR THE SALE OR PURCHASE OF THE PROPERTY?

A. We recommend that a taxpayer put language on the Purchase Agreement for both the Relinquished property and the Replacement property. This is to put all parties on notice that the taxpayer intends to effectuate a 1031 exchange, and if the taxpayer is audited, it will evidence that the taxpayer had the intent to effectuate an exchange from the very beginning.

We recommend language similar to the following:
On the agreement for the Relinquished property:
Purchaser herein acknowledges that the Seller intends to effectuate a 1031 tax-deferred exchange and that Seller may assign his rights and obligations under the Agreement in order to facilitate such exchange. Purchaser agrees to cooperate with Seller in executing any necessary exchange documentation without any additional cost or liability to Purchaser.

On the agreement for the Replacement property:
Seller herein acknowledges that the Purchaser intends to effectuate a 1031 tax-deferred exchange and that Purchaser may assign his rights and obligations under the Agreement in order to facilitate such

exchange. Seller agrees to cooperate with Purchaser in executing any necessary documentation without any additional cost or liability to Seller.

Q. WHAT WILL THE BASIS OF MY NEW REPLACEMENT PROPERTY BE?

A. The basis of the Replacement property would be the fair market value of the new property, less the realized gain (which is the net selling price after selling expenses, less the adjusted basis), plus the recognized gain. It is also calculated by taking the adjusted basis of the Relinquished property, plus the "boot" given, plus the mortgages on the Replacement property, plus the recognized gain, less the "boot" received, less the mortgages on the Relinquished property.

NOTE: Your tax advisor should be able to pinpoint the basis on your Replacement property, as the above are merely general formulas for determining your new basis.

Q. WHAT ARE THE TAX ADVANTAGES AND DISADVANTAGES OF EFFECTUATING A 1031 TAX-DEFERRED EXCHANGE?

A. A primary advantage is that by deferring the tax on the gain, a taxpayer will have the use of that capital for investment. Additionally, a taxpayer can expand his portfolio of investment or business parcels by acquiring the new Replacement property or properties. A disadvantage is that the basis of the Replacement property is essentially the same as the basis of the Relinquished property. This is referred to as a "transferred basis". The basis in the Replacement property is lower than it would have been had the old property been sold and the new property been purchased in separate transactions. Such a reduced basis results in smaller depreciation deductions. Also, a taxpayer will pay those capital gains taxes at the time he/she actually sells the Replacement property. The 1031 exchange process merely defers the payment of this capital gain tax-it does not eliminate it.

Q. WHAT ARE THE TIME PERIODS WITH WHICH I MUST COMPLY IN ORDER TO EFFECTUATE A 1031 EXCHANGE?

A. The IRS has VERY strict time periods a taxpayer must meet in order to qualify for the deferred tax treatment. There are two primary deadlines with which a taxpayer must comply.

1) IDENTIFICATION. A taxpayer must identify the Replacement property or properties within 45 days after the transfer of the Relinquished property. This 45 days includes holidays and weekends and there are no exceptions or extensions. The identification must be in writing and notice given accordingly, as set forth in the Exchange Agreement.

2) ACQUISITION. A taxpayer must actually acquire the Replacement property or properties within either 180 days of the transfer of the Relinquished property or the due date of the taxpayer's tax return, whichever is earlier. If a person is exchanging multiple properties, the identification period and acquisition period are determined by reference to the earliest date on which any of the properties are transferred.

Q. WHAT IF I WANT TO PURCHASE THE REPLACEMENT PROPERTY PRIOR TO SELLING THE RELINQUISHED PROPERTY?

This would be considered a "reverse" exchange. On September 15, 2000, the Internal Revenue Service issued a Revenue Procedure to provide a safe harbor for taxpayers engaged in a "reverse" exchange. If the transaction is structured properly, the taxpayer can now acquire the new property before disposing of their old property, and still avoid recognizing any gain. The taxpayer has 45 days after an Exchange Accommodation Titleholder ("EAT") acquires the Replacement Property to identify the Relinquished Property or Properties. The taxpayer then has up to 180 days (or the due date of the Taxpayer's return, including extensions, whichever first occurs) to acquire title to the Replacement Property and transfer title to the Relinquished Property to the ultimate purchaser.

This is just a brief overview of the Reverse Exchange process. There are several different types of reverse exchanges and the reverse exchange process is complex and typically more costly than a simultaneous or typical deferred exchange.

There are also several different methods used to avoid a true "reverse" exchange and still qualify for tax-deferred treatment:

1) The taxpayer can delay Replacement property acquisition until the Relinquished property can be sold. This may be done through use of an extended escrow or use of an option relating to the Replacement property;

2) The Replacement property can be "parked" or "warehoused" with an independent (unrelated) third party until the Relinquished property can be transferred, then a simultaneous exchange of the Relinquished and Replacement properties can be done; or

3) A taxpayer can do a simultaneous exchange with an independent third party who acquires the Relinquished property and then holds the Relinquished property until it can be sold.

As with any exchange, advance planning is highly recommended, particularly if the Taxpayer will be deviating from the standard or typical delayed exchange.

Q. CAN I IDENTIFY AND ACQUIRE AS MANY REPLACEMENT PROPERTIES AS I WANT?

A. A taxpayer may identify up to three properties without having a limit on the aggregate fair market value ("3 property rule") OR he can identify any number of properties as Replacement properties as long as the aggregate fair market value of those properties is less than or equal to 200% of the fair market value of the Relinquished property ("200 percent rule").

With regard to acquisition of the Replacement property, a taxpayer may identify three alternatives without regard to which of the three a taxpayer intends to acquire. If a taxpayer identifies more than three properties, then he must limit the total value of all identified properties to 200% of the value of the Relinquished property. Failure of a taxpayer to restrict himself to one of these two options (200% or 3 properties) may render the exchange invalid, since if a taxpayer exceeds these limits, he must acquire virtually all (95%) of all properties identified. However, a taxpayer may revoke some identifications and substitute others during the 45 day identification period, so long as he is able to satisfy the applicable limits at the end of the 45 day time period.

Q. CAN I SELL MY REPLACEMENT PROPERTY IMMEDIATELY OR MUST I HOLD ON TO IT FOR A CERTAIN LENGTH OF TIME?

A. There is no safe holding period for property to automatically qualify it as having been held for a qualified purpose. There has been a general consensus or recommendation that a taxpayer hold the Replacement Property for at least one year prior to any type of disposition of the property. Further, the IRS stated in a private letter ruling that a minimum two-year holding period would be a sufficient holding period for the qualified use test.

The Code does address the holding period with regard to transfers between related parties. If a taxpayer is exchanging with a related party, there is a minimum two year holding period. However, in one case the IRS ruled that an exchange was taxable under the related party rules of 1031(f) when the taxpayer sold the Relinquished Property to an unrelated party and acquired the Replacement property from his mother, using a Qualified Intermediary. (TAM 97480006). Therefore, we recommend that a taxpayer considering acquiring Replacement property from a related party should consult his/her attorney or accountant.

"Related party" includes, but is not limited to, family members, an individual andcorporation where more than 50 percent in the value of the stock is owned directly or indirectly by or for such individual, two corporations part of the same control group, a grantor and fiduciary of the same trust, a corporation and partnership if the same persons own more than 50 percent in value of the outstanding stock of the corporation and more than 50 percent of the capital interest or profits interest of the partnership.

Q. WHAT IF I IDENTIFY A REPLACEMENT PROPERTY WHICH IS TO BE PRODUCED/CONSTRUCTED?

A. In a deferred exchange, a transfer of Relinquished property will not fail to qualify for non-recognition of gain or loss, merely because the Replacement property is not in existence or is being produced at the time the property is identified as Replacement property. The transfer will qualify for non-recognition under IRC Sec. 1031, provided the party constructing the improvements does not act as the taxpayer's agent and the improvements are constructed prior to the taxpayer's acquisition of the Replacement property.

If the identified Replacement property consists of improved real property where the improvements are to be constructed, the taxpayer should provide a description for the underlying land and as much detail as possible regarding the construction of improvements at the time of identification. 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 taxpayer. Under the September, 2000 Revenue Procedure, a build-to-suit exchange may be structured using an EAT. This involves the drafting of additional documentation, complexity and will be more costly for a Taxpayer.

Q. WHAT IF THE REPLACEMENT PROPERTY IS NOT FINISHED AT THE END OF THE 180 DAYS OR THE DUE DATE OF MY TAX RETURN, INCLUDING EXTENSIONS?

A. In situations where a construction exchange is involved, improvements can be done by a third party prior to the taxpayer's receipt of the Replacement property. This third party may be the Purchaser of the Relinquished property, the Seller of the Replacement property, a contractor, a qualified intermediary, or some other independent third party. To ensure that the Replacement property received by the taxpayer is substantially the same as identified, "substantial changes" cannot have been made to the property as it has been identified by the taxpayer.

Moreover, if production of the real property is not completed on or before the date the taxpayer receives the property, the property will be considered to be substantially the same if, had production been completed at that date, the property received would be considered substantially the same property as identified ONLY to the extent the property is considered real property under local law.

NOTE: Any improvements done after the taxpayer has acquired the property will not be treated as receipt of like-kind property.

NOTE: Improvements that are constructed on land the taxpayer owns does not qualify for tax-deferred treatment under IRC Sec. 1031.

Q. WHAT DOES CORPORATE EXCHANGE SERVICES ("CXS") DO FOR, ME?

A. First, the IRS mandates that a tax-deferred exchange be handled through a "Qualified Intermediary." CXS is a Qualified Intermediary and will handle the transfer of funds so that a taxpayer will not be considered to have had actual OR constructive receipt of any monies, which is a requirement by the IRS. CXS will hold the taxpayer's exchange funds in an interest-bearing account, which will then be used to purchase the Replacement property.

Second, CXS will also draft the Exchange Agreement and all of the accompanying documentation involved in the exchange transaction, including all assignments, reassignments, and a complete accounting after the exchange is completed. In addition, we will work with the respective title companies or attorneys to ensure the closings on the relative transactions are being handled and the transfer of monies is accomplished correctly.

CXS was established in 1995 and has assisted in effectuating well over 400 taxdeferred exchanges. By using CXS, you will substantially eliminate the risk of the IRS setting aside the exchange, which would make it a taxable transaction. CXS always recommends that a taxpayer considering a 1031 exchange consult his or her accountant and/or attorney to determine all of the consequences of the exchange or whether the exchange would be beneficial for the taxpayer, as CXS is merely a facilitator and does not give legal or tax advice.

Q. WHAT IS THE FEE FOR CXS'S SERVICES?

A. The fees are very reasonable. In a "1 to 1" exchange (Disposing of 1 Relinquished property and acquiring 1 Replacement property) a fee of $600.00. Reverse Exchanges fees are typically $2,500.00-$3,500.00. In addition, there is a charge of $150.00 per additional property if there is more than one Relinquished or Replacement property involved.