

# Unraveling the Mystery of the **1031 Exchange**

We have answers.

*Go ahead, ask.*



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## Exeter 1031 Exchange Services

- Qualified Intermediary (Accommodator)
- Exchange Accommodation Titleholder
- Administers all types of 1031 Exchanges in all 50 states and foreign countries:
  - Forward 1031 Exchange
  - Reverse 1031 Exchange
  - Improvement 1031 Exchange
  - Zero Equity 1031 Exchanges<sup>™</sup>
- Real Property 1031 Exchanges
- Personal Property Exchanges
- Foreign Property 1031 Exchanges

## The 1031 Exchange

- Section 1031 of the Internal Revenue Code and Section 1.1031 of the Treasury Regulations
- Tax deferral strategy that allows an investor to sell rental, investment or business use assets and defer the payment of the income tax consequences by reinvesting in qualifying use, like-kind replacement property.

# 1031 Exchange Benefits

- Income Tax Consequences
  - Sale of real or personal property may trigger taxable gain
- Exchanging Throughout Your Lifetime
  - 1031 Exchange is more than a transaction tool, it's a wealth building tool
  - Keeps wealth in family
  - Swap 'til you drop
- Step-up In Cost Basis
  - Taxable gain goes away at death

## Why Use a 1031 Exchange?

- Adjustments are needed to an asset or portfolio.
- **Diversify** your real estate portfolio by number of properties, type, or location
- **Consolidate** your real estate portfolio with fewer properties, less management, no management
- **Reposition** your real estate portfolio by selling less profitable; lower yielding property and buy more productive; better cash flow/yield
- Tax consequences can be very prohibitive.
- Should put you in a better position

# 1031 Exchange Structures

- Forward 1031 Exchanges
  - Simultaneous/concurrent Exchanges
  - Delayed 1031 Exchanges
- Reverse 1031 Exchanges
  - Parking arrangement through Exchange Accommodation Titleholder
- Improvement (Build-To-Suit/Construction) 1031 Exchanges
  - Use 1031 Exchange funds to make improvements to the Replacement Property

# 1031 Exchange Qualified Intermediary (Accommodator)

- Role of the Qualified Intermediary
  - Prepare legal agreements and related transaction documents
  - Receive scratch that Received, hold and safeguard 1031 Exchange funds
  - Serve in an advisory and consultative role to guide clients through the 1031 Exchange

## Qualifying Use Property

- Investors INTENT is absolutely critical
- Property must be held for investment purposes, such as:
  - Rental (income production)
  - Investment (capital appreciation)
  - Business use
- Property held for sale (i.e., inventory) or personal use will not qualify
  - Rehabbing, flipping, wholesaling
  - Condo conversions, development



## Holding Period/Requirement

- No specific or required holding period exists in the code or regulations
- The only requirement is that the investor have the **INTENT** to hold the property for rental, investment or business use purposes.
- Advisors often recommend a holding period of at least 12, 18 or 24 months, but the length of time does not determine whether or not property meets the qualified use requirement.

## Like-Kind Property

- Real estate 1031 Exchanges
  - Any kind of real estate qualifies as like-kind property as long as the qualifying use requirement is met
- Personal property 1031 Exchanges
  - Property must be broken down into very specific asset categories
- Foreign property 1031 Exchanges
  - Foreign real property can be exchanged for other foreign property
  - Foreign personal property must be exchange for foreign personal property

## Like-Kind Property

- Investors can exchange between all of the following asset classes:
  - Single or Multi-family residential
  - Commercial office buildings
  - Retail shopping centers or strip malls
  - Industrial warehouses
  - Vacant, undeveloped, or farmland
  - Oil and gas interests, mineral rights, water rights, and air rights
  - Fractional ownership (TIC or DST)

## Non-Like-Kind Property

- Certain types of properties are specifically excluded and are not considered to be like kind or qualifying use property, such as:
  - Primary residences
  - Second homes
  - Vacation homes (personal use)
  - Anything with excessive personal use

## Non-Like-Kind Property

- Ownership interests in an entity generally do not qualify for 1031 Exchange treatment
  - Partnership interests in a partnership
  - Membership interests in a limited liability company
  - Shares of stock owned in a Corporation
  - Exceptions include disregarded entities such as single-member LLC's, land trusts, Delaware Statutory Trusts, and fully revocable grantor trusts

## Foreign Property 1031 Exchanges (Non-Domestic)

- Real or personal property located in foreign countries can also qualify for 1031 Exchange treatment if the qualified use and like-kind requirements are satisfied
- Qualified use and like-kind property requirements remain the same, except:
  - Real or personal property must all be located in foreign countries

## 1031 Exchange Deadlines

- Identification Period
- 45 calendar days ID Period
- Calendar days
- Begins at close of transaction (escrow)
- Strategies:
  - Delay closing date
  - Start looking for property early
  - Consider using TIC/DST properties

## 1031 Exchange Deadlines

- 1031 Exchange Period
- Complete your 1031 Exchange by:
  - the earlier of 180 calendar days or the due date of your income tax return, including extensions (only an issue when sale closes between October 17 and December 31 or any given year)
- 45 days plus an additional 135 days for a total of 180 calendar days
- **Not** 45 days plus 180 days
- Begins at close of sale transaction
- No extensions



## Identification Requirements

- Must comply with one of the following identification rules:
  - Three (3) property rule; OR
  - 200% of fair market value rule; OR
  - 95% exception
- The identification should be specific and unambiguous using either the street address, legal description or assessor's parcel number
- Identification should be delivered to the Qualified Intermediary

## Reinvestment Requirement

- In order to defer all of your income tax consequences, you must:
  - Have the **intent** to reinvest in like-kind replacement property
  - Trade equal or up in fair market value based on the net sale price
  - Reinvest 100% of equity/net cash proceeds into the replacement property
- You can always add cash but cannot withdraw cash without paying tax
- Partial 1031 Exchange transactions are permissible, but will result in some tax

## Partial 1031 Exchange

- Partial 1031 Exchange transactions are permissible and do not harm the overall 1031 Exchange transaction
- Pulling cash out of a 1031 Exchange transaction
- Trading down in value through a 1031 Exchange transaction
- Obtaining a larger loan or other debt on the property which results in cash left over

## Seller Carry-Back Financing

- Seller carry-back financing can significantly complicate your 1031 Exchange transaction
- Seller will receive some cash as a down payment, but will receive the balance in the form of a seller carry-back note
- Completing a 1031 Exchange transaction when the Qualified Intermediary is not holding all cash can get extremely complicated

## Taxpaying Entity

- Generally, the replacement property must be acquired by the same taxpaying entity that sold the relinquished property
- There are some exceptions to this rule such as disregarded entities, which can include:
  - Single member limited liability companies
  - Delaware Statutory Trusts
  - Land Trusts
  - Fully revocable grantor trusts

## Related Party Issues

- Related party transactions **MAY** be permissible with special review and analysis
- Selling relinquished property to a related party is permissible as long as the property is held for at least two years
- Buying replacement property from a related party is generally not permissible, but there are a few exceptions where it may be possible
- Revenue Ruling 2002-83 addresses related party transactions in greater detail

## Special Tax Planning Strategies

- Combining a 1031 Exchange with a 121 Exclusion
- Combining a Forward 1031 Exchange with or into a Reverse 1031 Exchange
- Structuring an Advanced Improvement 1031 Exchange transaction

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