# 1031 Exchanges Made Easy

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# 1031 Exchanges Made Easy

# What is a 1031 Exchange?

Section 1031 of the Internal Revenue Code provides that no gain or loss shall be recognized on the exchange of real property held for productive use in a trade or business or for investment. Simply put, a 1031 exchange allows you to defer the gain when selling and reinvesting in property used for business or investment purposes. It is much like a typical sale followed by a purchase but they are linked together by the exchange documentation and completed within the required timeframe.

A 1031 like-kind exchange is based on the continuity of investment. The underlying investment stays intact but the properties may change. Like-kind exchanges have been allowed since 1921 and have stayed in the tax code so long because they encourage reinvestment which helps the economy.

## Benefits of a 1031 Exchange

In addition to the obvious desire to defer gain, there are countless benefits to completing a 1031 exchange:

- Immediate tax deferral
- Time value of deferred gain
- Greater buying power
- Greater selling power
- Increased income potential
- Less management responsibility
- Diversification of investments
- Consolidation of properties
- Relocation of investment property or business
- Possible exit strategy for business owner
- Opportunity to depreciate higher basis replacement property
- Tax may be forgiven upon death of the Exchanger (heirs may receive stepped up basis)
- Defers appreciation gain as well as depreciation recapture and may avoid the 3.8% Net Investment Income Tax and Alternative Minimum Tax

# Requirements of a Succesful Exchange

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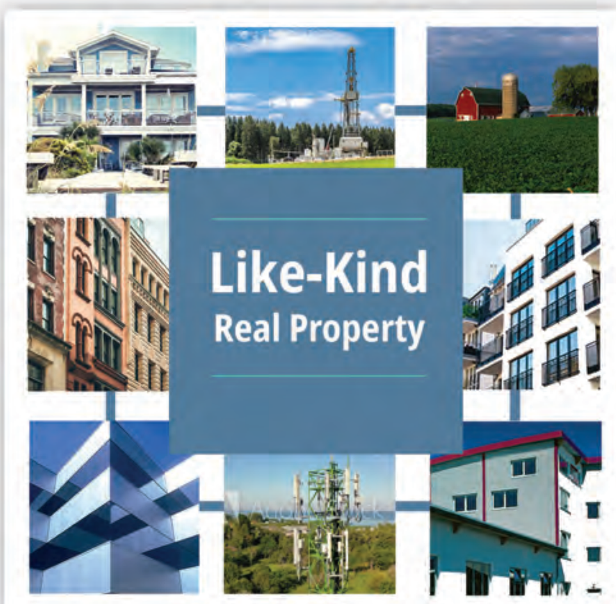
|---|---|---|---|---|---|
| All properties must be used for business use or investment | New property must be of equal or greater value and equity | Meet 45-Day Identification and 180-Day exchange deadlines | Same taxpayer must own all of the properties | A QI must be in place before closing of old property | No actual or constructive rights to exchange proceeds |

## Like-Kind Requirement

- Both the relinquished property and the replacement property must be held for productive use in a trade or business or for investment. Like-kind refers to the nature or character of the property and not the specific type of property.

- Properties may be located anywhere within the United States (50 states or Washington, D.C.). U.S. territories are not eligible although Letter Rulings 9038030 and 200040017 allowed the acquisition of rental property located in the U.S. Virgin Islands, Guam and the Northern Mariana Islands. U.S. property must be exchanged for other U.S. property.
- You can exchange foreign property held for business use or investment, but you cannot exchange U.S. property for foreign property or vice versa.
- You can buy or sell more than one property in an exchange.



## *Examples of frequently exchanged property:*

- Single family rental properties, duplexes, multi-unit apartment buildings
- Vacant land, farms and ranches
- Office buildings, warehouses, industrial buildings
- Retail properties
- 30-year lease, including options
- Conservation easements
- Tenant-in-common (TIC) interest
- Passive real estate such as Triple Net Lease (NNN) and Delaware Statutory Trust (DST) interests
- Cell tower and billboard easements
- Utility easements
- Oil and gas royalties, mineral rights, water rights, air rights
- Co-operatives
- Timber rights
- New Jersey Pineland Credits

## *Assets Ineligible for 1031 Treatment:*

- Tangible and intangible personal property/capital assets, such as furniture, fixtures and equipment, franchise agreements, client lists and liquor licenses
- Personal use properties such as principal residences and vacation homes
- Property held for sale such as “flips,” spec homes, building lots and other inventory
- Mortgages and notes
- Stocks and bonds
- Partnership interests
- Cash
- Goodwill
- Incidental property valued at more than 15% of the sale price

## Qualified Use Requirement

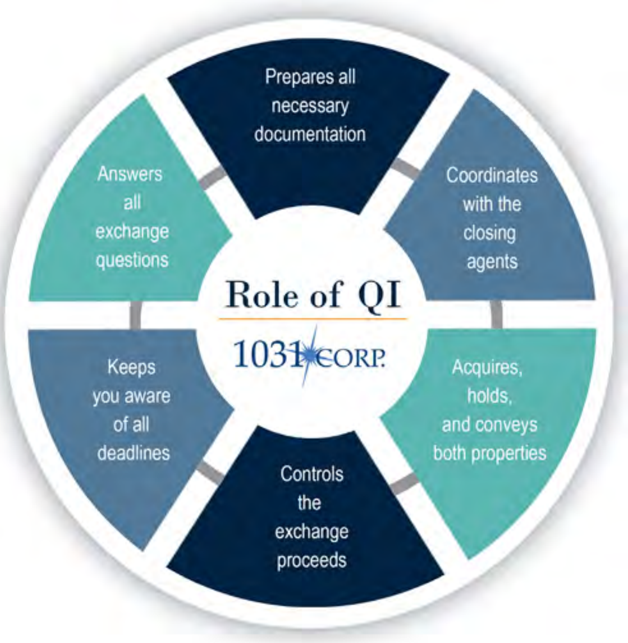
Both the relinquished property and the replacement property must be held for productive use in a trade or business or for investment. The specific length of time the property must be held for business use or investment is not defined. Based on case law, one to two years is a good rule of thumb, but intent is more important than the length of time held. There must be intent to hold indefinitely and maintain the property for business use or investment. You cannot acquire replacement property with the intent to resell immediately. Therefore, flips and teardowns and other property held for sale do not qualify.

### *What Qualifies as Investment Property?*

To qualify as an investment property, Section 280A of the Internal Revenue Code provides the owner must not use the property for personal use more than the greater of 14 days or 10% the number of days rented annually.

## Role of the Qualified Intermediary

A Qualified Intermediary (QI), such as 1031 CORP., is needed to act as the facilitator or middleman in an exchange. The word “qualified” refers to the QI’s relationship to the Exchanger. To be “qualified,” the QI must not be the actual Exchanger or the Exchanger’s accountant, attorney, real estate professional, financial planner, employees, partners or close relative. The QI cannot have provided real estate services, tax or legal advice within the past two years.




Both the relinquished property and the replacement property “flow” through the QI, although title passes directly from the seller to the buyer, just as in any typical real estate transaction.

### *When should the 1031 Exchange be Initiated?*

Ideally, the exchange will be initiated once the relinquished property is under agreement with a buyer. This allows your 1031 CORP. Exchange Officer to prepare and forward the exchange documentation with ample time for you to review and sign. It also enables your Exchange Officer to give the closing agent plenty of notice that the transaction is part of a 1031 exchange. If the exchange was not initiated in advance, 1031 CORP. can structure the exchange at the last minute, even while you are sitting at the closing table. However, once the closing is complete and title of the relinquished property is conveyed to the buyer, it is too late to initiate the exchange and the sale will be a taxable event.

1031 CORP. is covered under a multi-million dollar Errors and Omissions Policy to protect you in the unlikely event we made a mistake that created a taxable event for you. For a copy of our Evidence of Insurance, contact your Exchange Officer.

## Exchange Documentation

- The **Exchange Agreement** defines the role of the QI and outlines the relationship between the QI and the Exchanger. Through this agreement 1031 CORP. acquires, holds and conveys both properties and receives, holds and controls the exchange proceeds during the exchange. The Exchange Agreement must be signed at or prior to the closing of the relinquished property.
- The **Assignment of the Agreement of Sale** assigns the Exchanger's rights, but not their obligations, in the Agreement of Sale to the Qualified Intermediary. This assignment can be included in the Agreement of Sale or signed at closing. A hold harmless clause is included assuring the buyer of the relinquished property and the seller of the replacement property there is no additional cost or liability and closing will not be delayed as a result of the 1031 exchange. The assignment terminates once the closing is complete.
- The **Acknowledgement of the Assignment** is to be signed by the buyer of the relinquished property and the seller of the replacement property.
- The **Closing Statement** will indicate the transaction was part of a 1031 exchange and the QI will also sign.

## Identification and Exchange Periods

There are two important timelines that must be met to successfully complete a 1031 exchange. Both time periods begin at the closing of the first relinquished property and run concurrently. The time periods are based on calendar days and there are no extensions.


The **45-Day Identification Period** requires the identification of like-kind replacement property.

- The identification must be made in writing and signed by the Exchanger. An identification signed by an agent of the Exchanger, such as an attorney, accountant or real estate professional, and not the Exchanger will be an invalid identification.
- At any time before midnight on the 45th day, an identification may be revoked and a new one made. The time zone where the Exchanger resides is used for this purpose.
- To identify replacement property, the identified property does not need to be under Agreement of Sale with a seller.
- If like-kind replacement property has not been properly identified by midnight of the 45th day, the exchange will fail and the Exchanger will be unable to complete the exchange and defer the gain. All exchange funds and interest earnings will be released on the first business after the expiration of the 45-Day Identification Period.

**Word of Advice:** *There is no way to extend the 45-Day Identification Period but you can take advantage of the time you have before the 45-Day Identification Period starts. Begin looking for desirable replacement property before you have your relinquished property sold. You can sign an Agreement of Sale for the replacement property before conveying title of the relinquished property to a buyer. If an out-of-pocket earnest money deposit was paid for the replacement property, these funds may be able to be reimbursed from your exchange proceeds when you acquire the replacement property. Your Exchange Officer can coordinate this with you. The dates the Agreements of Sale are signed do not matter; the time deadlines are based on the actual conveyance dates.*

The **180-Day Exchange Period*** runs concurrently with the 45-Day Identification Period and requires the acquisition of all desired identified replacement properties. Signing an Agreement of Sale is not sufficient and you must actually take legal and equitable ownership of the replacement property on or before the 180th day.

**If the settlement of the relinquished property occurs between October 17th and December 31st of most years, for individual taxpayers, the 180-Day Exchange Period will be shortened to the due date of the federal income tax return of the next calendar year unless a timely and proper IRS extension is filed for their return. The extension will allow the full 180-Day Exchange Period to complete the exchange and until October 15th to file the return. Be sure to discuss any applicable estimated payments with your tax advisor.*

## *Federally Declared Disaster Extensions*

If you are in the unfortunate situation of being affected by a federally declared natural disaster, please contact your 1031 CORP. Exchange Officer immediately. Under Revenue Procedure 2018-58, you may qualify for an extension to your 45-Day Identification and 180-Day Exchange Period deadlines. Extensions are not automatic and they do not apply to state or local states of emergency or all federally declared disasters. IRS issues a Notice or News Release listing the affected areas. A list of affected areas can be found on Tax Relief in Disaster Situation page on the IRS website.

Extensions apply to reverse and delayed exchanges and provide the greater of either a 120-day extension or until the specific deadline date provided in the extension.

Taxpayers who may qualify for an extension are defined as follows: (a) An “affected taxpayer” as defined in IRC section 301.7508A-1(d)(1) of the Procedure and Administration Regulations; OR (b) Has difficulty meeting the 45-day identification or 180-day exchange deadlines for the following or similar reasons:

- The relinquished property or the replacement property is located in a covered disaster area;
- The principal place of business of any party to the transaction (for example, the qualified intermediary, exchange accommodation titleholder, transferee, settlement attorney, lender, financial institution, or a title insurance company) is located in the covered disaster area;
- Any party to the transaction (or an employee of such a party who is involved in the 1031 exchange transaction) is killed, injured, or missing as a result of the federally declared natural disaster;
- A document prepared in connection with the exchange (for example, the agreement between the transferor and the qualified intermediary or the deed to the relinquished property or replacement property) or a relevant land record is destroyed, damaged, or lost as a result of the federally declared disaster;
- A lender decides not to fund either permanently or temporarily a real estate closing due to the federally declared disaster or declared disaster or refuses to fund a loan to the taxpayer because flood, disaster, or other hazard insurance is not available due to the federally declared disaster; or
- A title insurance company is not able to provide the required title insurance policy necessary to settle or close a real estate transaction due to the federally declared disaster.

The extension also applies to relief workers affiliated with recognized charities and government agencies assisting in the affected area.


# 45-Day Identification Rules

## *The 3-Property Rule*

You may identify up to three properties regardless of their combined fair market value. You are not obligated to purchase all three properties but must purchase at least one of the three identified properties to successfully complete the exchange.

For example, if selling a relinquished property for $100,000, three replacement properties can be identified with a combined fair market value of $1,000,000.

## *The 200% Value Rule*

You may identify more than three properties but their combined fair market value cannot exceed double (200%) the fair market value of the relinquished property.

For example, if a relinquished property was sold for $100,000 and four or more replacement properties are identified, their combined fair market value cannot exceed $200,000 (200% or double the sale price of the relinquished property).

*Many find the 200% Rule very confusing. Please keep in mind that it only applies if identifying four or more properties. If identifying one, two or three properties, there is no limit to the combined fair market value amount of the properties.*

*The asking price is usually considered the fair market value.*

## *Exceptions:*

- Any replacement property acquired within the 45-Day Identification Period will be treated as properly identified, but must be included in the calculations if additional properties will be identified.
- If the 3-Property Rule and 200% Value Rule are violated, the property will still be treated as properly identified, provided 95% of the combined fair market value of the identified replacement property has been acquired.
- For example, assume a $100,000 property was sold and five properties with a combined fair market value of $800,000 are identified. This will be treated as properly identified provided all five properties are acquired.

## Same Taxpayer Requirement

Any taxpayer, whether an individual, married couple or entity, can complete an exchange. However, title to the replacement property should be held the same way title of the relinquished property was held. The only exception to this rule would be the use of a disregarded entity.

- A single-member limited liability company (LLC) where the sole member is the same taxpayer that sold the relinquished property.
    - Except in a community property state, a married couple wishing to use a single-member LLC to acquire the replacement property would have to create a separate single-member LLC for each spouse and each LLC would acquire a 50% tenant-in-common interest in the replacement property.
    - If using a single-member LLC, the Taxpayer would have to elect to be treated as a disregarded entity for tax purposes.
- An Illinois Land Trust (Rev. Ruling 92-105) is treated as a disregarded entity. Numerous other states now allow similar disregarded land trusts.
- A revocable living trust (Rev. Rul. 92-105, Rev. Rul. 70-376 and Rev. Rul. 88-103) will also qualify as a disregarded entity.

## No Actual or Constructive Rights to Exchange Proceeds

The exchange funds must be held by the QI until all replacement property is acquired or the end of the 180-Day Exchange Period. You cannot have actual or constructive rights to receive, pledge, borrow or otherwise obtain the benefits of the exchange proceeds held by the QI. You do have the right to earn interest earnings on the exchange funds while held by the QI and the interest is restricted the same as the principle.

*1031 CORP. deposits your exchange funds in a highly liquid, segregated interest-bearing savings account. A new exchange account that includes your name and taxpayer identification number (TIN) is opened for each exchange. Many internal safeguards are in place to protect your exchange funds while they are held by 1031 CORP. A Qualified Escrow Account (QEA) is always available at no additional charge. A QEA is a three-party agreement between you, the bank and 1031 CORP. and both you and 1031 CORP. must provide written instructions to the bank prior to the bank processing the withdrawal. The 1031 CORP. Banking Team works hard to secure competitive interest rates for your exchange account. Exchange funds are never pooled or co-mingled. All funds held by 1031 CORP. are covered by a multi-million dollar Fidelity Bond. For a copy of our Evidence of Insurance, please contact your Exchange Officer.*

# When Funds Can Be Released From Exchange Account

Exchange proceeds can be released from the exchange account for earnest money deposits and the acquisition of identified replacement property, including routine closing costs, with written authorization signed by the Exchanger. Exchange proceeds cannot be used to cover mortgage acquisition costs, such as points, application fees and processing fees. In order to have funds released for earnest monies, the Agreement of Sale for the replacement property must be assigned to 1031 CORP., as the qualified intermediary. If you paid an out-of-pocket deposit on the replacement property, it can be reimbursed from the exchange funds at the time of acquisition if there are enough funds.

If no replacement property is identified within the 45-Day Identification Period, unfortunately, there is not a valid exchange and the sale is a taxable event. Exchange funds will be released from the exchange account on the next business day. In no case can exchange funds be released or the exchange cancelled until the expiration of the 45-Day Identification Period. If replacement property was identified and you opt to not acquire one or all of the identified replacement properties, the exchange funds must be held by the QI until the expiration of the 180-Day Exchange Period. The regulations prevent the early release of funds.

# Tax Consequences of Exchanging

## Maximizing the Tax Deferral

To maximize the tax-deferral, you must acquire replacement property equal or greater in value than the net selling price of the relinquished property (contract sales price less routine transaction expenses). The equity in the replacement property must be equal or greater than the net equity in the relinquished property (contract sales price less routine transaction expenses less the mortgage payoff, if applicable). Many question the requirement to have equal or greater debt on the replacement property, but as long you acquire replacement property with equal or greater value and equity, you will satisfy the necessary requirements. You can use additional out-of-pocket funds, obtain new financing or a combination of both.

## Trade Downs and Taxable Boot

A trade down in value or equity creates a taxable event. The taxable portion in a 1031 exchange is considered “boot.” You are taxed on the greater trade down. There may be a benefit to completing a 1031 exchange even if you intend to trade down in value or equity but you should discuss the transaction with your tax advisor.

## Advisory

1031 CORP. cannot provide tax or legal advice. Always discuss your situation with your tax and/or legal professional before proceeding with a 1031 exchange. A 1031 exchange is an excellent tax strategy, but it is not the right one in every situation.

## Basis of Replacement Property

The basis of the replacement property is lowered by the deferred gain. Essentially, the basis is carried to the new property and increased by any additional property value acquired.

## Depreciation of Replacement Property

T.D. 9115 (2/27/04) is a clarification of Notice 2000-4. The basis of the replacement property acquired in a 1031 exchange is generally the same as that of the relinquished property less any cash received plus any gain recognized. Notice 2000-4 clarified how MACRS replacement property in a 1031 exchange should be depreciated. The MACRS replacement property should be treated in the same manner as the MACRS relinquished property with respect to so much of your basis in the replacement property as does not exceed your adjusted basis in the relinquished property. The replacement property is depreciated over the remaining recovery period and using the same depreciation method and convention as that of the relinquished property. Any excess basis in the replacement property is treated as newly acquired MACRS property. There will generally be at least two different depreciation schedules in place on one asset. Notice 2000-4 applies to properties placed into service on or after January 3, 2000. T.D. 9115 gives you the option to elect out of this depreciation treatment.

## Deferral of State Gain

A 1031 exchange is allowed under section 1031 of the Internal Revenue Code and allows the deferral of federal gain. All states with an income tax regime either follow the federal tax code or have adopted their own version of like-kind exchanges except the Commonwealth of Pennsylvania.

### *Pennsylvania Advisory*

Pennsylvania is the only state with an income tax regime that does not recognize a like-kind exchange. Therefore, when a Pennsylvania resident sells property, regardless of where it is located, or a non-resident of Pennsylvania sells property located in the state, the Pennsylvania income tax will be due on the gain. Fortunately, the current income tax rate for individual Pennsylvania taxpayers is 3.07%, low compared to many other states. While you cannot defer the state income tax, you can still defer the federal gain. The exception to this is a Pennsylvania c-corporation, which does follow the federal tax code, and can defer the Pennsylvania income tax as well. Note, exchange proceeds cannot be used to pay the Pennsylvania income tax without having to pay federal gain on the funds excluded from the 1031 exchange.

## NON-RESIDENT WITHHOLDING TAX

Many states have enacted mandatory non-resident withholding taxes that must be withheld at the time of sale if the seller is not a state resident. Closing agents in these states must submit a check representing the required withholding tax to the Recorder of Deeds in order to record the deed. If completing a 1031 exchange, you may request an exemption, but most states require the necessary documentation be filed ***prior*** to closing.

*The following states currently have non-resident withholding requirements: California, Colorado, Delaware, Georgia, Hawaii, Maine, Maryland, Mississippi, New Jersey, New York, North Carolina, Oregon, Rhode Island, South Carolina, Vermont and West Virginia. Keep in mind other states may enact laws requiring a non-resident withholding tax. Your 1031 CORP. Exchange Officer and your closing agent will be very helpful with this.*

## REFINANCING THE REPLACEMENT PROPERTY

After the exchange is complete, there is nothing to prevent you from refinancing and taking equity out of the replacement property without triggering a taxable event.

# Principal Residences and Vacation Homes

## Sale of Principal Residence

Homeowners who have resided in their residence for at least two of the last five years may be eligible for the Principal Residence Exclusion allowed under Section 121 of the Internal Revenue Code. Single taxpayers are entitled to a $250,000 exclusion from gain and married taxpayers, filing jointly, are entitled to a $500,000 exclusion from gain. An exclusion allows you to have a gain on the sale of your principal residence up to the maximum limit without having to pay capital gain taxes. Any gain over and above these exclusion limits is taxable.

To qualify for the exclusion, you must have lived in the property for a minimum of twenty-four months during the last sixty months. The twenty-four months do not have to be contiguous as the IRS allows you to aggregate your time living in the house to meet the two-year residency requirement. The exclusion is available once every two years and there is no limit to the number of times you can take it. When taking the $500,000 exclusion, both spouses must meet the eligibility test and have resided in the property for the full twenty-four months to qualify for the full exclusion. If not, one spouse only may qualify for the exclusion.


You may be eligible for a partial exclusion when failing to meet the two-year period because of special conditions, such as a change in health, employment more than 50 miles away or other unforeseen circumstances. Members of the military are entitled to full exclusions regardless of the length of time they resided in the property if they move to satisfy service commitments.

## Mixed-Use Property Exchanges

Properties involving mixed uses (combining personal and business use) can be exchanged. The portion of the property used for business use will qualify for tax deferral treatment under Section 1031. Depending on its use, the portion of the property used for personal use may qualify for the principal residence exclusion under Section 121. Additionally, one can acquire a property that would have mixed uses. Some examples of properties that may have mixed uses are owner occupied duplexes, bed & breakfasts and farms.

## Conversion of Replacement Property to Principal Residence

After using 1031 exchange replacement property for business use or investment, you can convert the property to a personal use property. Generally, under Section 121 of the Internal Revenue Code, if used as a principal residence for at least 24 months within the last five years, you can exclude $250,000 in gain and $500,000 if married, filing jointly. You cannot have taken the Section 121 exclusion within the past two years. However, under HR 4520 (The Jobs Act), signed by President George W. Bush on October 22, 2004, properties acquired in a 1031 exchange must be owned for at least five years and used at least 24 months of the last five years before qualifying for the Section 121 exclusion. Under Section 121, regardless of whether or not a 1031 exchange was involved, you cannot exclude depreciation recapture from May 6, 1997 forward.

The Housing Assistance Tax Act of 2008, signed by President George W. Bush on July 30, 2008, includes a modification to the Section 121 exclusion of gain on the sale of a principal residence. This modification affects those who convert a rental property into a principal residence. Effective January 1, 2009, the Section 121 exclusion no longer applies to gain from the sale of the residence that is allocable to periods of “nonqualified use.” Nonqualified use refers to periods that the property is not used as the taxpayer’s principal residence. This change applies to use as a second home as well as a rental.

# Exchange of Vacation Homes

During the spring of 2007, IRS provided important guidance regarding the exchange of vacation homes in Moore v. Commissioner, T.C. Memo (2007-134). In this case, the taxpayer acquired a vacation home on a lake a few hours drive from their home. The family visited the property almost every weekend between April and September for several years. After the family relocated and the drive was a few hours longer, they exchanged the property for another lake property that was closer to their principal residence and taxpayer resumed their pattern of using the property almost every weekend during the warm months. Neither property was ever rented nor did they attempt to rent. The exchange was challenged and the Taxpayer unsuccessfully argued that they held the property for investment and it should qualify. The exchange failed and the tax courts ruled holding a vacation home, in part, with an expectation of future appreciation is insufficient to justify the classification as held for investment.

In September 2007, the Office of the Treasury Inspector General of Tax Administration (TIGTA) issued a report stating a need for more oversight of 1031 exchanges. The report advised IRS to provide taxpayers with guidance on the exchange of vacation homes and it also recommended IRS conduct a study of exchanges. The report also targeted those that promote the exchange of vacation homes which could include attorneys, tax advisors, real estate agents and qualified intermediaries.

As promised, the IRS has provided guidance on the exchange of vacation homes in the form of a "safe harbor" provided in Revenue Procedure 2008-16 which created the ability for vacation property owners to exchange for another vacation home. To qualify for the protection of the "safe harbor," the taxpayer must follow all of the rules. A summary of the safe harbor requirements are as follows:

## *Relinquished Property:*

- Taxpayer owns the relinquished property for at least 24 months before selling;
- Taxpayer rents the relinquished property for at least 14 days for each of the two 12-month periods immediately preceding the sale;
- Cannot rent to a related party unless it is a year rental and related party uses the property as his/her year-round principal residence and pays fair market value rent; and
- Taxpayer cannot use the property for personal use more than 14 days or 10% the number of days the property was rented, whichever is greater.

## *Replacement Property:*

- Taxpayer must rent the replacement property for at least 14 days for the two 12-month periods immediately following the acquisition;
- Cannot rent to a related party unless it is a year rental and related party uses the property as his/her year-round principal residence and pays fair market value rent;
- Taxpayer cannot use the property for personal use more than 14 days or 10% the number of days the property was rented, whichever is greater; and
- If taxpayer is unable to satisfy the requirements on the replacement property, he/she must amend his/her return and report the sale of the relinquished property as a taxable sale and not a 1031 exchange.

As with all investment properties, owners can still stay at the property while making improvements or for business use reasons without it being considered personal use.

The Revenue Procedure provides planning opportunities for those who own vacation homes and want to exchange it for a more desirable property without capital gains. A taxpayer can establish a long-term plan to sell a vacation home, minimize personal use of the property to no more than 14 days per year and rent the property for a minimum of 14 days per year for the two 12-month periods preceding the anticipated sale. Owners can still enjoy the summer holidays and qualify. While it does prevent the property owner from enjoying the properties year-round for four full years, it may be well worth it to defer the gain. There is no requirement to acquire another vacation home. A "qualifying" vacation home can be exchanged for other business or investment property or vice versa.

## Related Party Exchanges

Section 1031 exchanges between related parties should be carefully considered as these types of transactions have received considerable attention over the years due to concerns of basis shifting.

Under Internal Revenue Code Sections 267(b) and 707(b), a related party is anyone who bears a relationship to the Taxpayer. Any one of the following is considered a related party:

- Family members such as siblings, spouse, ancestors and lineal descendants.
- Individual and corporation where more than 50% in 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 a fiduciary of the same trust.
- A fiduciary and a beneficiary of the same trust.
- A fiduciary of a trust and the fiduciary or beneficiary of another trust where the same person is the grantor of both trusts.
- A fiduciary of a trust and a corporation where more than 50% in value of the outstanding stock in which is owned, directly or indirectly, by or for the grantor of the trust.
- A corporation and partnership if the same persons own more than 50% in value of the outstanding stock of the corporation and more than 50% of capital interest or profits interest in the partnership.
- An S-corporation and another S-corporation or a C-corporation if the same persons own more than 50% of the value of the outstanding stock of each corporation.
- Two partnerships in which the same persons own, directly or indirectly, more than 50% capital interests or profit interests.
- A partnership and a person owning, directly or indirectly, more than 50% capital interests, or profits interest, in such corporation.

If your relinquished property is sold to a related party, the related party must hold the property for at least two years before listing the property for sale, entering into an agreement to sell or transferring title.

It may be acceptable to acquire replacement property from a related party in one of the following situations and you will be subject to the mandatory two year holding period mentioned above:

- The related party also completes a 1031 exchange and neither party has boot;
- The related party pays more tax than you would have paid without a 1031 exchange; or
- You acquire a larger tenant-in-common interest in property you already own.

# Improvement Exchanges

Improvement exchanges allow you to use the proceeds from the exchange of your relinquished property to make improvements to the replacement property. This usually happens when the fair market value of the replacement property is less than that of the relinquished property. If you were to simply acquire the replacement property and construct the improvements, the improvements would not qualify as like-kind property. Therefore, you cannot take title to the replacement property until the improvements are completed. Typically, the Qualified Intermediary (QI) (or an affiliate of the QI, such as Reverse 1031 CORP.) will create a Special Purpose Entity (SPE) to take title to the replacement property directly from the seller, sign the contract with the builder and have the improvements completed. Once the improvements are completed, the SPE conveys title to you at the higher price to complete your 1031 exchange.

The improvements must be identified within the 45-Day Identification Period and title of the improved property must be transferred to you by the end of the 180-Day Exchange Period. It is not necessary for the improvements to be 100% complete prior to title being acquired from the SPE and your price of the replacement property will be equal to the original purchase, including costs, plus the improvements completed and paid for at the time of transfer. However, the replacement property must be substantially the same property that was identified.

Improvement exchanges do require more planning than a typical delayed exchange but are an excellent solution if you want to use exchange funds to make improvements to the replacement property. To maximize the 180-Day Exchange Period, arrangements should be made so the SPE can take title to the property soon after the relinquished property is conveyed to a buyer. All permits should be secured, the contract with the builder signed and financing in place so construction can begin immediately.

There are additional expenses including fees for the SPE and transactional expenses to the closing agent. There may also be duplicate title insurance premiums, loan costs and transfer taxes. *Please contact your Exchange Officer for more information.*

# Reverse Exchanges

Most taxpayers know about the tax-deferred benefits of a 1031 exchange, but many are not as familiar with reverse exchanges. A reverse 1031 exchange is a strategy used when you want to acquire the replacement property prior to conveying title of the relinquished property to a buyer. The most common situations leading to a reverse exchange are as follows:

- You have found the ideal replacement property but have not yet sold or closed on your relinquished property.
- You must settle on the replacement property or lose substantial down monies and/or favorable financing.
- A Buyer of your relinquished property has not been found or falls through at the last minute and the closing on the replacement property cannot be postponed without jeopardizing the transaction.

Our reverse exchanges are structured under Revenue Procedure 2000-37 which provides a 180-day “safe harbor” period to “park” title until the exchange can be completed. Under this structure, we create an entity to act as the Exchange Accommodation Titleholder (EAT), bound by a Qualified Exchange Accommodation Arrangement (QEAA) which is essentially a “parking” arrangement. As an exchange is considered the continuation of the original investment, you cannot own both the relinquished and the replacement properties at the same time. To facilitate the reverse exchange, title to either the relinquished or the replacement property is held by an EAT until the relinquished property can be conveyed to a buyer. The Revenue Procedure allows the EAT to “park” title for a maximum of 180 days.

In today’s market, investors often locate the replacement property before putting the relinquished property on the market. A reverse exchange is often preferred because investors want the time to locate the desired replacement property without the pressure of the 45-Day Identification Period timeclock ticking. The reverse exchange provides the opportunity to sell the property at market value without forcing a fire sale. A reverse exchange can also afford the opportunity to complete improvements on the replacement property prior to giving up the relinquished property which is often essential when relocating a business.

To acquire the property, the EAT borrows the funds from the exchanger or more often from the exchanger and a third-party lender. During ownership by the EAT, the EAT leases the property to the investor through a triple net lease which gives the exchanger the opportunity to report the income and expenses on the exchanger’s tax return.

Reverse exchanges do take more planning and cost slightly more than a typical forward exchange but are certainly well worth the time and expense to preserve the tax-deferral treatment under Section 1031.

*A reverse exchange is more complicated and takes longer to structure, especially when a lender is involved. Please contact your Exchange Officer for more information.*

## Advisory

*Every 1031 exchange is unique. This information provides an overview of the 1031 exchange requirements. You should always discuss your situation with a tax and/or legal advisor. 1031 CORP. cannot and does not provide tax and/or legal advice.*