Internal Revenue Code (IRC) Section 1031 Tax Deferred Exchanges

by George Stott

NOTE: This paper is a basic overview of IRC section 1031 tax deferred exchanges. It is not intended to be a guide to such an exchange, as it omits rules and considerations that could impact upon someone actually conducting a 1031 exchange.

NOTE: This paper will use the terms "old property" for the property being sold and "new property" for the property being purchased. A property can consist of more than one piece of real estate.

NOTE: We have participated a large number of 1031 exchanges and usually have several such transactions in escrow at any given time. However, we are not licensed to provide either legal or tax advice. Licensed professionals such as attorneys or CPA's should be consulted for such advice.

1. What is an IRC section 1031 tax deferred exchange? How does it differ from a Starker Exchange?

Section 1031 of the Internal Revenue Code (IRC) provides for the deferment of long-term capital gains taxes on the sale of investment real estate when it is exchanged for other investment real estate of equal or greater value than the real estate being sold. The term "Starker Exchange" is still used at times to describe the process. Mr. Starker agreed to sell his Oregon timberland if the buyer would hold the proceeds until Starker found a suitable replacement property. Prior to then, exchanges were done simultaneously with buyers and sellers essentially sitting down at a closing table and trading deeds. Starker's successful 1979 court case allowed for non-simultaneous exchanges and people began to refer to the process by his name.

2. What is meant by investment real estate?

For purposes of this paper, investment real estate is defined as any real estate other than your primary residence or a second home. It is usually a rental property that is either residential; e.g., a house, townhouse, condo, etc. or commercial; e.g., an office building, warehouse, strip shopping center, etc. However, it could also be vacant land.

3. How do I find someone who wants to exchange or trade investment real estate with me?

A common misconception is you need to find someone to trade properties with you. Most 1031 exchanges involve two entirely separate transactions. In one, you sell old property and in the other, you purchase new property. There is no reason for the buyer of your old property and the seller of the new property to have any contact with each other. Often, the properties are located in two different states.

The IRS mandates that you use a completely independent third party in an exchange to prepare the legal documents. Because this third party must be completely independent, it cannot be your real estate agent, accountant or attorney. The independent third party is usually referred to as an intermediary or qualified intermediary (QI); however, in some areas of the country the third party may be called either a facilitator or an accommodator. This paper will use the term "QI." The QI can be located anywhere; i.e., it does not need to be located near either the old or the new property.

The following steps have now been changed; however, they help explain the role of the QI. The QI takes title to the old property for a brief instant in the process of having it sold from you to the buyer; i.e., title passes from you through the QI to the buyer. Similarly, the QI takes title to the new property for a brief instant in the process of having it sold from the seller to you. Therefore, the QI has owned both the old and the new properties and can exchange one for the other.

Today, the QI no longer has to have held title to both properties. In 1991, the real estate industry successfully lobbied Congress to have the law changed, as escrow companies were charging double escrow fees; e.g., seller to QI and then QI to buyer. Instead of taking title to both properties, the QI is now tasked to provide instructions so that both transactions are closed in a manner that conforms to Section 1031 of the IRC. When the old property closes, the proceeds from the sale go to the QI who banks the funds until you're ready to purchase the new property. The QI then makes the funds available for your subsequent purchase of the new property.

4. Why do the proceeds from the sale go to the QI?

You cannot have access to any funds from the sale of the old property or those funds will be taxable. The QI places the funds (your money) into a savings account. The interest that accrues is usually paid to you after the 1031 exchange has been completed.

NOTE: Some intermediaries retain the interest on your funds as part of their compensation. If you are shopping for a QI, this may be a cost to consider. See question #24.

5. What if I don't want to buy the same kind of property I'll be selling?

A 1031 exchange is an exchange of investment real estate for investment real estate. It does not need to be the same kind of property nor does it have to be one for one. You can exchange commercial property for residential property or vice versa. Or, you can exchange one property for several properties or vice versa.

6. Can I exchange the old property into a new residence for myself?

No. A 1031 exchange involves investment real estate being exchanged for other investment real estate. However, exchangers sometimes change their minds and occupy property they had intended for rental purposes. In October 2004, new federal regulations were issued as to how long an owner had to have owned a principal residence they had acquired through a 1031 exchange before they could sell it and exclude some or all the capital gain under the Tax Relief Act of 1997, refer to questions #27 & #28. Most tax experts believe this change to the federal regulations legitimized the process of conducting a 1031 exchange into new property that the exchanger rents for awhile so it qualifies as rental property and then occupies as their principal residence.

7. How long do I have to rent a property that I want to use as a future residence?

This is a question to discuss with your tax advisor and QI. Obviously, the longer it is rented, the easier it is to show investment intent. In the past, there were three different opinions: (1) at least one year and a day; (2) a period of time long enough to enable two tax returns to be submitted showing it to be rental property; and (3), at least two years. Recently, there has been a decided movement towards the one-year and a day criteria. Following the October 2004 change to federal regulations, several attorneys wrote explanations as to how the change would impact upon owners. Every explanation I read that was prepared by an attorney used the year and a day criteria.

8. Can I rent new property to a related party?

Yes, however, the rent must be fair market rent for the property. Moreover, the rental payments must be able to be documented. Otherwise, the IRS may rule that the property is merely a second home, which would not qualify for a 1031 exchange. If you decide to rent to a related party, you should consider setting up a separate bank account with all rental payments sent there to make it easier to document that fair market rent was actually paid.

9. Can a related party be involved in the 1031 exchange?

Section 1031 of the IRC states that you cannot sell to or buy from a related party unless both parties hold the properties for two years after the exchange. A related party includes your parents and grandparents, your siblings, your spouse, your children and grandchildren, and any business organizations where you or your relatives are members. The IRS has been getting increasingly tough in this area as evidenced by the need now to provide a written statement as to whether a related party was involved in the exchange, refer to question #23.

10. Can I exchange into vacant land and build a house?

Yes, this is commonly referred to as a construction exchange. Most exchangers want the new property to include the house rather than just the vacant land. This can create timing problems in view of the 180-day requirement to close on the new property, refer to question #11. Therefore, a construction exchange usually necessitates considerable advance planning along with the use of a very experienced QI. Normally, a limited liability company (LLC) is established that acquires the lot, initiates contracts with the architect/builder and has the house constructed. Financing for these actions is usually provided by the exchanger outside of the exchange; i.e., not from the old property. When the new house has been completed, the lot and house are then deeded to the exchanger as the new property.

11. What are the time requirements associated with a 1031 exchange?

Most 1031 exchanges are deferred exchanges. First, the old property is sold and then the new property is purchased. **There are two key time frames both measured from the closing date of the old property. Failure to meet either of these time frames negates the tax-deferred 1031 exchange.**

a. <u>Within 45 days, the new property must be identified in writing to the QI.</u> You can make changes to your identification within the 45-day period; however, on the 46th day, you are locked-in to whatever has been identified as new property.

b. <u>Within 180 days, the new property must close</u>. You can identify several new properties, refer to question #15. If your selected new property falls out of escrow, you could shift to different new property that was identified; however, it would still have to be closed within the 180-day period.

The 180-day period starts on the closing date of the old property and ends on the 180th day thereafter or the due date (including extensions) for the taxpayer's return. Therefore, if you close on the old property near the end of the year, you may need to file for an extension on your tax return that is normally due on April 15th if you need the full 180 days.

12. Are there any other requirements involved in conducting a 1031 exchange?

a. The new property must be at least as expensive as the old property (sales price less closing costs). If the new property is less expensive than the old property, the difference in value will be taxable. Sometimes the difference can continue to be withheld and used for improvements to the new property and not be taxed. Discuss this with your QI.

b. You must take title to the new property exactly as title was held to the old property. If the lender needs your spouse to co-sign a mortgage to the new property and be on title, your spouse must also be on title to the old property.

<u>NOTE:</u> Trusts that do not file a tax return, like a revocable living trust, are usually disregarded for 1031 exchange purposes. Therefore, the owner of a trust is treated as an individual in selling the old property and can subsequently take title to the new property in their own name. This can be very

important, as many lenders will not provide mortgages to trusts. If you own the old property in a trust, this is something you should discuss with your QI and attorney.

13. How does the average person afford to buy more expensive investment real estate?

They use the equity they have in the old property as a downpayment on the more expensive new property. For example, if you own old property worth $350,000 with a mortgage balance of $150,000, you have $200,000 of equity in the property ($350,000 less $150,000). Using a 20% downpayment, the $200,000 would enable you to buy a new property for $1 million. The rent that you expect to receive from the new property would be used to help you qualify for a mortgage on the new property.

14. I own one-half of a property with my brother owning the other half with title being in both of our names. He wants to cash his half out while I want to conduct a 1031 exchange with my half. Is this possible?

As a general rule, yes; however, this is something you need to discuss with your QI. And, you would need to take title to your new property exactly as you held title to your half-interest in the old property.

15. What is involved in identifying the new property?

Within 45 days of closing on the old property, the address (or legal description) of the new property must be provided to the QI. You can identify up to three separate properties as new property. If more than three separate properties are identified, their combined value may not exceed 200% of the value of the old property. The ability to identify several properties is designed to provide backup in case your originally planned new property falls out of escrow. Many exchangers identify 2-3 separate properties as the new property. If the first cannot be purchased, they may still be able to close on another within the 180-day period.

The new property can consist of several different properties. If you plan to purchase several different properties as the new property, the identification rule can create problems. Assume the old property had a value of $350,000 and you have found four separate houses, each of them with a value of $200,000, that you want to buy as the new property. You do not need to identify until the 45th day. However, if you do identify, you could only identify three of the $200,000 houses, as the combined value of more than three; i.e., all four houses, would exceed 200% of the $350,000 value of the old property ($700,000) since 4 x $200,000 = $800,000. Therefore, to buy all four houses in the 1031 exchange, you would have to close on them prior to the 46th day.

16. Can you do it backwards; i.e., buy the new property first and then sell the old property?

This is called a reverse exchange. In 2000, the tax laws were modified to simplify the reverse exchange process. In a reverse exchange, the QI usually takes title to either the new or the old property using a separate legal entity called a limited liability company (LLC). Establishing an LLC creates additional legal and accounting fees. Moreover, financing can become considerably more difficult to obtain. A less complicated and less expensive approach would be to buy the new property with a long-term close (or using an option with a long option period) in order to delay the closing and provide time to sell the old property and conduct a normal deferred exchange. A more detailed discussion of a reverse exchange lies beyond the scope of this paper, as almost all of our 1031 exchange clients conduct a deferred exchange.

17. Could I buy Real Estate Investment Trust (REIT) shares as my new property?

No. The IRS has ruled that REIT shares do not qualify as real estate in an exchange. A REIT is like a mutual fund that owns real estate; it is a security, not real estate. There is an exception for a special

type of REIT called an UPREIT or Umbrella Partnership REIT but there are restrictions; e.g., you can't exchange out of an UPREIT to buy actual real estate.

18. Are there any restrictions on leasehold property?

Yes. A leasehold property **must have at least 30 years remaining until the expiration of the lease (the expiration date, not the renegotiation date). Many leasehold properties on Oahu no longer qualify, as their leases are now too short**; the list of such properties grows each year.

19. I understand that I cannot have access to any funds from the sale of the old property. Could I refinance the old property before I exchange it?

This is a gray area. If you were to refinance the old property in the year prior to selling it, you could have a problem with the IRS, as they might argue that your refinancing was done to circumvent the prohibition of receiving funds from the old property. On the other hand, if you could show the funds from the refinancing were used strictly for bona fide investment purposes, you might have a counter argument. You should discuss this with your attorney and QI.

20. Could I use funds held by the QI for costs associated with the new property like earnest money or having a feasibility study done prior to purchasing it?

The QI can only advance funds from your account for items that will be refunded if closing doesn't occur, the most common example being earnest money. The cost for items like a feasibility study, architect fees, etc. would not be refunded if the deal fell through; therefore, the QI cannot advance funds for those purposes. However, if those costs are shown on the settlement statement at closing, they can be paid at that time with funds from your account held by the QI.

21. Does a 1031 exchange defer Hawaii capital gains taxes as well as Federal capital gains taxes? What happens with HARPTA?

Yes, both Hawaii and Federal taxes are deferred. **Note that the taxes are not excluded; they are deferred** and could be subject to collection if you subsequently sell the new property without conducting another 1031 exchange.

HARPTA is a Hawaii law (similar to laws of other states such as California) that enables Hawaii to collect (estimated) capital gains taxes from non-resident owners selling real estate in Hawaii who might not file a Hawaii income tax return. Under HARPTA, the state collects **5% of the sales price** at closing with subsequent refunds if the collected amount is too high. If the non-resident owner is conducting a 1031 exchange, the withholding under HARPTA is waived. The Stott Team has a separate special report that discusses HARPTA at **http://stott.com/sellers-harpta.html**

22. What are the current Federal and Hawaii capital gains taxes?

The federal capital gains tax rate for most taxpayers is 15% on all components of gain but depreciation recapture. The federal capital gains tax rate for taxpayers in a 15% or lower federal tax bracket was reduced from 5% to 0% on 1/1/08 for a three-year period of time. The 15% federal tax brackets in 2009 are expected to be up to $33,950 (single) and up to $67,900 (joint return). If you are married and earn less than $67,900 in 2009, it would initially appear that you might not have to pay federal capital gains taxes; however, capital gains from the sale of real estate is added to your taxable income to determine your capital gains tax bracket. For example, if you are married and have $50,000 of taxable income and $40,000 of capital gains, there would only be $15,100 ($67,900 less $50,000) exposed to the 0% rate; the remainder of the capital gains would be exposed to 15%. Depreciation recapture is taxed at 25% regardless of your federal income tax bracket.

The Hawaii capital gains tax is 7.25% on all components of gain including depreciation recapture. Since state taxes are deductible for Federal tax purposes, the total combined tax bite for most exchangers is about 21% (vice 15% + 7.25% = 22.25%) on everything but depreciation recapture and about 31% (vice 25% + 7.25% = 32.25%) on depreciation recapture. Hawaii taxes for non-resident owners are collected at closing via HARPTA. Federal taxes are paid at the time a federal tax return is submitted for the year of the sale.

23. How do I report a 1031 exchange to the IRS?

IRS Form 8824 is a 2-page form that must be submitted in the year that you sold your old property. This form has two recent changes:

a. You will be required to state on the form whether your 1031 dealings were with a related party, refer to question #9.

b. You will be required to include the name/address of the QI, refer to question #24.

24. How do I locate a QI?

We can provide you guidance based on our experience working with 1031 exchanges. QI's are not regulated either by the federal government or by most states; therefore, there may be some less-than-reputable individuals out there. This is an area where you want everything to be done correctly. The change to IRS Form 8824 requiring the exchanger to provide the name/address of their QI will enable the IRS to build a QI-client database. If they subsequently discover a QI has been abusing the rules, they will have a list of all the QI's past clients for audit purposes.

I would only use as a QI, a company or individual that is experienced, bonded and works with exchanges on a full-time basis; i.e., I would not use an attorney as a QI who only does it on a part-time basis. If it were a relatively simple one-for-one exchange, I would probably use the exchange division of a large escrow company. Many of our clients use an escrow-associated individual on Oahu as their QI. If my exchange were complicated involving establishing an LLC (refer to questions #10 & #16), I would explore using a large Mainland QI company. Such companies are usually very consumer-oriented, responding well to questions. Moreover, they work with LLC's all the time and may be able to minimize some of the additional administrative costs.

25. What is the cost of a QI?

For an exchange of old property on Oahu to new property on the Mainland, the Oahu escrow company that many of our clients use charges $600 and retains the interest on the exchanger's funds (held by the QI from the close of the old property to the close of the new property). One of the large, Mainland companies charge $850 and provide the exchanger all the accumulated interest after the exchange has been completed. There are other QI's that will charge $1,500 and up to handle such an exchange. If the exchange is involves LLC's, the cost is likely to be in the $3,500 and up range.

26. What advice can you provide on locating a new property?

It normally takes at least 30 days (about 45 days on Oahu) to close on real estate once an offer is accepted. Assuming another 30 days to get an offer accepted; i.e., on-market time from list date to acceptance of an offer, you should have at least two months from listing the old property to closing on it. The 45-day identification period begins at closing, so you should have at least 3-4 months to locate new property after listing the old property for sale.

Most of our clients fall into one of two categories. The first category includes owners who have already found property that they plan to use as their new property or who will be searching for a

future residence. The first category also includes owners who already own several investment properties and/or have done prior 1031 exchanges. Individuals in this category usually have a good idea as to how they are going to go about locating their new property.

In the second category are owners who are very open to ideas and suggestions as to what to use as new property. If their new property will be on the Mainland, we recommend such owners consider relatively inexpensive, new construction, single-family houses (or possibly townhouse or high-rise units). These usually have excellent rental potential, minimal maintenance for several years and above average appreciation for the area. In addition, newly built homes usually make it very easy to conform to the timing requirements. You probably want to use relatively inexpensive properties, as rents do not normally keep pace with housing values; i.e., a $400,000 home does not normally rent for twice as much as a $200,000 home.

If you plan to use newly built homes as replacement property, much of the initial searching will involve looking at advertisements in the real estate section of the Sunday newspaper and driving to various new construction projects. For new property other than new construction, you should use knowledgeable real estate agents to assist you. Most real estate agents specialize in handling either residential or commercial real estate. Very few are knowledgeable about both. Ask your friends and acquaintances for input. We also can provide you input, as most of the better agents hold special real estate designators they have acquired through schooling and experience; we have nationwide rosters of such agents.

If you are considering newly built homes, we recommend you familiarize yourself with various new development tracts that appear to be promising. If you have sufficient equity from the old property to exchange into more than one home, you might want to diversify and select more than one tract. Most developers build their projects over a period of time; i.e., each month more homes are finished in the tract. However, it's not unusual for developers to experience delays in their schedules, so keep in mind the 180-day requirement to close. Be wary of any developers that don't have a history of routinely completing homes they sell within 90-120 days.

Once you know your desired tract(s), there is little to do until you actually get an offer accepted on your old property. At that time, most developers will either sell you a specific house/lot subject to the sale (close) of your old property or they will try to reserve a selection for you. If you have a contract subject to the sale of your old property, you've bought a home once your old property closes. You then have 180 days in which to close on the new property. If the developer has tried to reserve a desired property for you, when your old property closes you can then proceed with its purchase or, if necessary, identify and buy the one next door. You still have 45 days to identify, so there's no real pressure on you except for the need to close within 180 days.

27. Explain the impact of the October 2004 change to the Tax Relief Act of 1997.

The Tax Relief Act of 1997 enables a homeowner to sell their principal residence and exclude up to $500,000 of gain (married) or up to $250,000 (single) providing they have occupied the home for an aggregate 24 out of the prior 60 months. Under the October 2004 change, an owner who acquired their residence via a 1031 exchange must own the property for at least five years before they sell to be eligible for the exclusion with the property being a rental for at least one year to qualify for the 1031 exchange and then with it being a principal residence for at least two years out of the past five years to qualify for the Tax Relief Act exclusion. The exchanger will also have to pay depreciation recapture on depreciation claimed (after May 6, 1997) while the property was a rental; i.e., depreciation recapture while the property was a rental will not be excluded.

28. Explain the impact of the Housing and Economic Recovery Act of 2008.

This law reduces the capital gains that can be excluded when a homeowner sells a primary residence that they acquired via a 1031 exchange, as the amount of the tax exclusion will be adjusted by the non-resident use of the property. The law becomes effective 1/1/09. The amount of time of non-resident use after 1/1/09 will be the numerator of a fraction with the denominator being the total time since property acquisition. That fraction times total gain (exclusive of depreciation recapture after May 6, 1997) is the gain that will be taxed to the homeowner.

> **Example:** Single Mary bought her Oahu home on 1/1/93 for $200,000 and rents it for 18 years until 1/1/11 when she occupies it as her primary residence. Two years later, on 1/1/13, Mary sells the property for $500,000 and has $300,000 of gain.
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> The non-residence use of the property by Mary prior to 1/1/09 does not apply to the new law. Therefore, Mary has only two years of non-residence use that applies from 1/1/09 to 1/1/11 when she then occupies it as her primary residence for two years. Mary will have owned it for a total of 20 years. Therefore, the fraction for non-resident use is 2/20. Or, the taxable gain is $300,000 x 1/10 or $30,000. The remaining $270,000 exceeds the $250,000 limit for single Mary, so Mary ends up with $50,000 taxable ($30,000 + $20,000) and $250,000 that is excluded. Mary would also owe depreciation recapture after May 6, 1997 that is taxed at 25%.
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> In my example, I used a long period of ownership before the eligibility date. If the property were acquired after the 1/1/09 eligibility date, the fraction will be much larger. For example, assume the property is acquired on 1/1/09, rented for three years and then occupied for two years, the non-resident use would be 3/5 or 60%. However, if it is rented for only one year and then occupied for four years, the non-resident use would only be 1/5 or 20%. Every day it is a rental property after 1/1/09 increases the capital gains taxes to the owner.

Granted, the new law has no impact if the owner never sells the property; however, few homes remain suitable for the same family over any extended period of time. Over time, most families desire a different location and/or a larger/smaller/more prestigious or a completely different type or style of home particularly after they retire or become empty nesters.

29. 1031 exchanges . . . some final thoughts.

A 1031 exchange is not the right investment tool for everyone. Over the years, we have assisted many owners in making a decision **not to conduct an exchange**. Often, all that was required was for us to estimate the owner's capital gains taxes. Contact me toll-free (1-800-922-67811), locally (808-254-1515) or via e-mail (team@stott.com) and I'll provide you the benefit of having worked with numerous exchange clients. If desired, I'll estimate your capital gains taxes. This is a free service we provide owners of rental properties on Oahu. I can estimate your taxes much more accurately if I know how you have been depreciating your property. Please note the depreciation figure found on line 20 of the Schedule E (Supplemental Income and Loss) to your most recent federal tax return (Form 1040).