1031 Exchange Overview

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 in a large number of 1031 Exchanges and usually have several such transactions in escrow at any given time. However, neither Stott Real Estate, Inc., nor any of our agents or employees, is licensed to provide either legal or tax advice. Licensed professionals such as attorneys or CPAs should be consulted for legal or tax advice.

1. What is an IRC section 1031 Tax Deferred 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. A common misconception is that you will have to find someone to trade properties with you. Most 1031 Exchanges involve two entirely separate transactions. In one transaction, you sell your old property and in the other, you purchase your new property. There is normally 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; e.g., most of our exchanges involve property in Hawaii being exchanged for property on the mainland.

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. Why should I participate in an exchange?

Most exchangers use 1031 Exchanges to defer capital gains taxes, as the capital gains tax can be significant. However, other reasons can include:

- Leveraging dollars that would otherwise be spent on taxes
- Replacing a non-income producing property with income-producing property
- Diversifying a portfolio and minimizing risk

4. What does deferring taxes mean?

A 1031 Exchange enables an owner to be able to defer both the federal and state capital gains taxes that they have on the sale of their old property and roll those taxes over into the new property. Note that the taxes are deferred, not excluded, and could be subject to collection if you subsequently sell the new property without conducting another 1031 Exchange. Deferred means to suspend or withhold until a certain time.

5. What is the exchange value of my property?

Basically, the value would be the sales price less closing costs.

6. 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 that enables Hawaii to collect (estimated) capital gains taxes from non-resident owners selling real estate in Hawaii. Under HARPTA, the state collects 7.25% 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. Stott Real Estate, Inc. has a separate special report that discusses HARPTA at **http://stott.com/for-sellers/harpta/**

7. What time requirements are associated with a 1031 Exchange?

There are two key time frames both measured from the closing date of the old property. **Failure to meet either of these two time frames negates the tax-deferred 1031 Exchange.**

- **Within 45 days, the new property must be identified in writing to the Qualified Intermediary (QI).** You can make changes to your identification any time within the 45-day-period; however, on the 46th day, you are locked-in to whatever has been identified as the new property.
- **Within 180 days, the new property must close.** You can identify more than one property; so if your preferred new property falls out of escrow, you could shift to a replacement new property that was identified during the 45-day-period; however, it would still have to be closed within the 180-day-period. Most exchangers identify more than one new property.

8. What is involved in identifying the new property?

To defer all your capital gains taxes, you must buy new property that is equal to or higher in value than the old property. Again, the value would be the sales price less the closing costs. You must also reinvest all the cash proceeds from the sale into the purchase of the new property. The QI maintains the funds from the sale of the disposable property and then makes those funds available in order to enable the purchase of the new property. **You cannot have access to any of the proceeds from the sale of the old property or those funds will be taxed.**

You must identify a new property within 45 calendar days after the closing date of the old property. The identification is only valid if the new property has been designated as such in a written document signed by you (and any other party on title) and delivered (hand-delivered, mailed, faxed, scanned and emailed, etc.) to the QI.

There are 3 guidelines to use when selecting properties:

- **3-Property Rule:** Three properties, regardless of what the fair market value is; or
- **200% Rule:** Any number of properties, as long as the combined fair market value does not exceed 200% of the fair market value of all of the old properties; or
- **95% Rule:** Any number of properties without regard to value, provided 95% of the value of the identified properties is acquired.

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

The current federal capital gains tax rate for single taxpayers with an Adjusted Gross Income (AGI) less than $426,700 and married couples filing jointly with an AGI less than $480,500 is 15% on all component of gain except depreciation recapture. Single taxpayers with an AGI greater than $426,700 or married couples with an AGI greater than $480,500 will be subject to a capital gains tax rate of 20%. The capital gains rates listed are for the tax year 2018 and are subject to change. Please consult your personal tax professional for a more detailed breakdown.

Federal Depreciation Recapture is taxed at 25%. You can find how you have depreciated the property on line 18 of your Schedule E.

The Hawaii capital gains tax rate is 7.25% on all components of gain including depreciation recapture.

Single taxpayers with an AGI greater than $200,000 and married couples filing jointly with an AGI greater than $250,000 will also be subject to the 3.8% Medicare Tax. Please consult your personal tax professional for a more detailed breakdown.

10. What is a Qualified Intermediary (QI)?

The IRS mandates that you use a completely independent third party to supervise the exchange. 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 either as an intermediary or as a 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 in the country; they do not need to be located near you or near either of the properties involved in the exchange.

The following steps have 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 hold 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; i.e. Seller to QI and then QI to you. Today, in lieu of taking title to both properties, the QI is tasked to provide instructions so that both transactions are closed in a manner that conforms to section 1031 of the IRC.

11. 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.

We would only use a QI, a company or individual that is experienced, bonded and works with exchanges on a full-time basis; i.e., we 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, we would probably use the exchange division of a large escrow company.

12. What is the cost of a QI?

For a relatively simple one-for-one exchange of old property on Oahu to new property on the Mainland, the Oahu exchange company that many of our clients use charges about $900 plus about $250 for each replacement property. For a one-for-one exchange, a cost of about $1,150 is similar to what most QI's charge. Some QI's will charge a lower base fee and retain the interest earned on the exchanger's funds (held by the QI from the close of the old property to the close of the new property). So, if you are comparing costs, ask about the interest.

If the exchange is complicated and and/or involves LLC's, the cost is likely to be in the $3,500 and up range.

13. 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.

NOTE: Some QI's 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.

14. 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, tax advisor and/or QI.

15. Could I use funds held by the QI for costs associated with the new property like earnest money (aka initial deposit) 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. 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.

16. What is boot?

Boot is anything given or received by the exchanger that is not like-kind or does not qualify under 1031 rules. Boot can be in the form of cash, promissory note, or in the form of debt (like a mortgage). Any boot received in connection in the sale of the old property that is not offset by the boot given on obtaining the new property, is gain that must be recognized (or taxed).

Boot-netting Rules:

- Cash paid on buying the new property offsets the cash received on the sale of the old property;
- Cash paid on buying the new property offsets debt relief on the sale of the old property; and
- Debt acquired or assumed on the new property offsets the debt relief on the sale of the old property.

NOTE: Debt assumed on the purchase of the new property will not offset the cash received on the sale of the old property.

17. Can I do a partial exchange?

Yes. However, any money that you use from the proceeds of your sale will be considered as boot and therefore will be taxed.

18. What kinds of properties qualify for an exchange?

Both the old property and the new property must be investment real estate; in most cases they are rental properties. The two properties do not need to be the similar; e.g., you could exchange a house in Hawaii for two or more Mainland condos and vice versa. Almost any type of real estate qualifies such as a house, condo, store, office or even vacant land. Your personal residence or a second home does not qualify. However, you could rent the new property first so that it qualifies as investment property and then occupy it yourself at a later date. Many of our clients do this; i.e., they use equity in their Oahu property to assist them in purchasing a future Mainland residence.

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.

A vacation home being sold must meet the following criteria to qualify for a 1031 Exchange:

- The taxpayer must own the property for at least 24 months before the exchange.
- In each of the two twelve-month periods, (1) the taxpayer rents the vacation home at a fair rental rate for 14 days or more **and** (2) the taxpayer's personal use of the vacation home does not exceed the greater of 14 days or 10 percent of the number of days during the twelve-month period that the vacation home was rented at a fair rental rate.

A vacation home being purchased must meet similar criteria to qualify for a 1031 Exchange:

- The taxpayer must own the property for at least 24 months following the exchange.
- In each of the two twelve-month periods, (1) the taxpayer rents the vacation home at a fair rental rate for 14 days or more **and** (2) the taxpayer's personal use of the vacation home does not exceed the greater of 14 days or 10 percent of the number of days during the twelve-month period that the vacation home was rented at a fair rental rate.

If the 1031 Exchange involves a vacation home, consult with your CPA or Attorney.

19. If I own a property that includes my personal residence and a rental unit, would it qualify for an exchange?

Yes. Consult with your CPA or tax advisor to determine the percentage value of the property you have attributed to investment. You may exchange that portion of the value.

20. 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.

21. 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. Many 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. You should discuss this with your Attorney and QI.

22. Can I defer taxes when I sell my primary residence?

No, but you can exclude up to $250,000 of gain if you are single or $500,000 if you are married. There are other rules that may apply to this exclusion.

The Housing and Economic Recovery Act of 2008 places additional limits on the capital gains exclusion for those individuals that have either converted a primary residence into a rental or have made a previous rental property into their primary residence.

If the property has been used as a rental after 2009, then the capital gains exclusion is reduced by the following fraction:

> (Number of days taxpayer rented property after 1/1/2009) divided by (Number of days taxpayer owned property)

If the sale of the home results in capital gains that exceed the allowed exclusion, then the taxpayer must report the taxable gain and pay the appropriate capital gains taxes.

23. 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.

24. 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.

25. 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.

26. 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. 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.

27. Are there any other requirements involved in conducting a 1031 Exchange?

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. 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.

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

With some very few exceptions, all of the exchanges made by our clients have been deferred exchanges where the old property is sold prior to purchasing the new property. It is possible to do this in reverse order and purchase the new property first; i.e., prior to selling the old property. This is called a reverse exchange. It is more complicated and a bit more expensive than a deferred exchange. This article is based upon deferred exchanges. Over half of our deferred exchanges involved absentee owners conducting their first 1031 exchange.

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

Many of our first-time exchangers first look at properties in Hawaii. After reviewing the cash flow though, they often end up purchasing investment property on the mainland. The clients often choose areas they currently live in, areas they visit often, or areas they hope to retire to one day. In our experience, we suggest that you choose an Agent or company that can provide both the sale and the property management information. Ideally, the same company you purchase through will manage the property for you after the sale closes.

30. 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 down payment 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% down payment, the $200,000 should 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.

31. 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.

32. 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.

33. 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.

34. 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.

- You will be required to state on the form whether your 1031 dealings were with a related party.
- You will be required to include the name/address of the QI.

35. Recent rules.

Three relatively recent rules apply to principal residences. The tax relief act of 1997 enabled a homeowner to sell their principal residence and **exclude up to $500,000 of gain (married) or up to $250,000 (single)** providing they had occupied the home for an aggregate 24 out of the prior 60 months. So an owner only needed to own the property for three years, one year as a rental to qualify for the exchange and then two years as a principal residence to qualify for the tax relief act of 1997. In October 2004, there was a change to the 1997 law. An owner who acquired their principal residence by way of a 1031 Exchange must now own the property for at least five years before they sell it in order to be eligible for the exclusion. The owner still needs to rent it for enough years so it qualifies for the exchange and then have it be their principal residence for at least two years. The exchanger also has 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.

The Housing and Economic Act of 2008 reduces the capital gains that can be excluded when a homeowner sells a principal residence that they rented, as the amount of the tax exclusion will be adjusted by the non-resident use of the property. This law became effective 1/1/09. The amount of time of non-resident use after 1/1/09 is the numerator or top of a fraction with the bottom or denominator of the fraction 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 1/1/98 for $200,000 and rents it for 13 years until 1/1/11 when she occupies it as her primary residence. Seven years later, on 1/1/18, 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 our example, we 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 four years, the non-resident use would be 3/7 or 43%. However, if it is rented for only one year and then occupied for seven years, the non-resident use would only be 1/7 or 14%. 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.

36. What are the other ways to conduct an exchange?

There are four ways to conduct an exchange. The first is to conduct a deferred or delayed exchange as discussed in this paper.

The other three are as follows:

- **The Reverse Exchange:** This occurs when the new property is acquired prior to the sale of the old property.
- **The Simultaneous Exchange:** This occurs when the old property and the new property both close at the same time.
- **The Improvement Exchange:** This occurs when you wish to use proceeds from the exchange to make capital improvements to the new property.

37. 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 is required is an estimation of the selling basis, buying basis, and accumulated depreciation. Contact us toll-free (1-800-922-6811), locally (808-254-1515), or via email (home@stott.com). Due to the added complexity from recent tax law changes, we recommend that you speak with a Certified Public Accountant (CPA) or tax attorney prior to deciding on a course of action. Due to the value of real estate on Oahu, you will likely be pushed into the higher tax brackets if you have owned the investment property for a significant period of time and the resulting tax bill could be costly if you don't conduct a 1031 Exchange.