

## **1031FEC**

### **Frequently Asked Questions**

#### **§1031 Basics**

Q Why would one want to do an Internal Revenue Service (IRS) Internal Revenue Code (IRC) §1031 Exchange?

***To defer capital gains tax on the sale of commercial, business, or investment property.***

Q Is a §1031 Exchange a loophole in the Internal Revenue Code?

***No. Section §1031 has been a part of the Internal Revenue Code since 1921.***

Q What type of property is eligible/not eligible for a §1031 Exchange?

***Your residence is not eligible for §1031 treatment. Your residence has other tax advantages. Any other property that is not held for commercial, business, or investment purposes is also not eligible.***

Q Is §1031 only for capital gains?

***No. §1031 applies to capital gains taxes (15%), depreciation recapture (25%), and state income taxes (generally 8% to 9% where applicable). Long-term capital gains taxes apply to property held over 1 year – gains from property held less than a year are taxed as ordinary income. Corporations may have depreciation recapture at corporate income rates up to 39% plus state corporate income tax rate to 12%.***

Q How do I start a §1031 Exchange?

***You must contact a Qualified Intermediary before you sell your property, so that you can complete the appropriate documentation and structure the exchange.***

#### **Qualified Intermediary**

Q Do I have to use a Qualified Intermediary?

***Using a Qualified Intermediary is the most common way to receive 'safe harbor' protection for your §1031 Exchange.***

Q Can't my own attorney or CPA serve as my Qualified Intermediary?

***No. A Qualified Intermediary must remain completely independent and cannot have been your agent in the past 2 years.***

## **1031 Timeframes**

Q Do I have to know what property I will be purchasing when I start the exchange?

**No. You have 45 days from the sale of your relinquished property to identify your potential replacement properties.**

Q How long do I have to purchase my replacement property?

**You have 180 days from the sale of your relinquished property by which you must close on the purchase of your replacement property/properties.**

Q What happens if my 45th or 180th day falls on a Saturday, Sunday, or holiday? Are there any extensions to these dates?

**As a general principle, there are no extensions for either the 45 or the 180-day rules. However, the IRS can provide an extension to these deadlines. Recent examples include the terrorist attacks of September 11, 2001 and recent Hurricanes.**

## **Property Identification**

Q How many potential replacement properties may I identify?

- **3-property rule:** You may identify up to 3 properties without regard to their value.
- **200% rule:** You may identify more than 3 properties provided that their combined fair market value does not exceed 200% of value of the relinquished property.
- **95% rule:** You may identify any number of properties, provided that you acquire 95% of those properties.

## **Napkin Rule**

Q Do I have to acquire a property of equal or greater value?

**Yes, in order to completely defer the applicable capital gains tax. To the extent you purchase a property of lesser value, you will be taxed on the difference.**

Q Do I have to use all the cash proceeds from my sale on my purchase?

**Yes, in order to completely defer the applicable capital gains tax. To the extent you do not use all your proceeds on the purchase, you will be taxed on the difference.**

Q Do I have to obtain a mortgage on my replacement property in the same amount or same percentage of debt as I had on my relinquished property?

**No. Just follow the above rules.**

Q Does Seller Financing jeopardize my exchange?

***Seller Financing is considered boot, which means it is taxable in the year(s) that it is paid (considered an 'installment sale'). There is a possibility that the Seller Financing (Note) can be placed into the exchange without paying taxes, but the note would have to be paid off or sold before the purchase of the replacement property.***

### **Construction Exchanges**

Q May I purchase replacement property that is not yet built?

***Yes, provided that the improvements on the property are completed prior to the expiration of the 180 days. This is a Construction Exchange with greater complexity and fees. In a Construction Exchange, the property is held by a specially formed LLC called the EAT (Exchange Accommodation Taxpayer).***

### **Reverse Exchanges**

Q May I purchase replacement property before I sell the property that I own?

***Yes. This is a Reverse Exchange with greater complexity and fees. Reverse Exchanges must be initiated before you purchase the replacement property. Again, the property is held by an EAT.***

### **Exchanger: Partnerships/Corporations/Individuals**

Q May a corporation or partnership be involved in a 1031 exchange?

***Yes, provided the entity selling the relinquished property is the same as the entity purchasing the replacement property. Corporations or Trusts that are 100% owned by the same entity are considered "Disregarded Entities", and the same entity for §1031 purposes.***

Q Are there any age restrictions on the exchanger (i.e. are people over a certain age exempt from paying taxes)?

***No.***

### **Relinquished Property – Holding Period**

Q How long must I hold my current property in order for it to qualify for a §1031 Exchange?

***Property involved in a §1031 Exchange must be held for "investment or productive use in a trade or a business."***

***When looking at "investment intent" the courts will often look to the period of time over which***

*the property is held. That said, there is no specific holding period requirement for either the relinquished or replacement property*

*Taxpayers who hold their relinquished property for two years satisfy the requisite intent for a §1031 Exchange (or two tax reporting periods, since in an audit the IRS may look backwards and forwards two tax returns). A holding period of over a year has generally been accepted, but may be subject to review by the IRS. A much shorter holding period has been accepted, where a change in circumstances indicates that the taxpayer had intended to hold the property for a longer period. The IRS will look at 'investment intent' and will call a taxpayer quickly flipping property a 'dealer' vs. an 'investor'.*

### **Relinquished Property – Personal Residence**

Q May I use my personal residence in a §1031 Exchange?

*No. If, however, a portion of your property is held either for productive use in a trade or business or for investment, that portion may be eligible for §1031 treatment.*

Q What if I live on part of the property?

*The taxpayer can split the transaction between §1031 and the personal residence exemption (Section 121: \$250,000 for an individual or \$500,000 for a married couple).*

Q What about a Second Home?

*If the taxpayer has claimed the residence as a second home on their tax returns, they likely cannot consummate a §1031 Exchange. If the taxpayer has lived in the residence over two weeks, the residence is a second home and will not qualify for 1031 treatment. The two weeks can be shorter if 10% times the number of days that the residence is rented a year is less than two weeks.*

*Example 1: a residence rented 200 days cannot be lived in by the taxpayer more than two weeks.*

*Example 2: a residence rented 83 days cannot be lived in by the taxpayer more than 8 days.*

Q May I do a 1031 Exchange, and later move into the replacement property as my personal residence?

*You cannot purchase the replacement property with the intent to move into it as a personal residence. If, however, you hold the replacement property for a sufficient time to establish the requisite intent for a §1031 Exchange, then you may move into the property and thus change the nature of the use of the property.*

*After moving into the property, a taxpayer may look to take the Section 121 exemption for personal residences. Under the recently enacted law, to gain the 121 exemption, the property must not have been the subject of a 1031 exchange in the previous 5 years (that's 5 years from the closing of the phase 2 acquisition).*

### **Relinquished Property – Foreign Properties**

Q What about foreign properties?

***Property within the United States must be exchanged for property within the United States. Property outside the United States can be exchanged for property outside the United States, but not with property within the United States. The United States, for purposes of §1031, includes the US Virgin Islands, if you are doing business there.***

### **Relinquished/Replacement Property – Incidental Costs**

Q What costs or fees are reimbursable to the taxpayer?

***Any that are incidental to the sale or purchase. Fees associated with loans, rental deposits, etc., must be covered by cash in the purchase of the replacement property, or will be considered boot.***

Q What happens when I need to make a down payment on my replacement property?

***Your Qualified Intermediary may directly wire the down payment from the funds held on your behalf. Alternatively, you may make the down payment and be reimbursed at the closing of the purchase of your replacement property.***

### **Tax Deferral vs. Tax Savings**

Q Is a 1031 Exchange tax-free?

***A §1031 exchange defers taxes; it generally does not eliminate them. The replacement property will carry the tax basis of the relinquished property – which means that upon the sale of the replacement property all tax will be due, or the taxpayer can enter into another §1031 Exchange. The deferred basis can be replaced with a new current value basis for heirs at the death of the owner.***

Q How can deferral turn into savings?

***If the replacement property is purchased with investment intent, and later converted to a personal residence, the taxpayer may receive Section 121 exemption from a certain amount of taxes (\$250,000 for an individual or \$500,000 for a married couple). Again, to gain the 121 exemption, the property must not have been the subject of a §1031 exchange in the previous 5 years. Also, at the time of the death of the taxpayer, the interested parties may be able to take the estate tax-free. This would depend on the applicable inheritance laws at that time (currently at \$2,000,000 for an individual). The deferred basis converted to current value basis for heirs at the death of an owner also is savings (again, considering applicable inheritance law estate tax).***

## **Tenancy-In-Common**

Q What is a Tenancy-In-Common?

***A tenancy-in-common is a form of ownership of real property whereby two or more individuals own an undivided interest in the property, and upon an owner's death, the interest passes to the owner's heirs. Interests in tenancies-in-common are usually divisible, and can be placed into a §1031 Exchange independently.***

Q What is a TIC?

***A TIC is a type of tenancy-in-common that is offered as a replacement property investment to §1031 exchangers. TIC's have Sponsors that purchase the property and apply for financing on the property. The properties are generally triple-net with A-rated tenants. TICs are sometimes sold as securities and sometimes as real estate. The SEC classifies TIC's as securities (if not both securities and real estate). As a security, they can only be sold by a securities broker-dealer, and investors are given special disclosures and protections. Some TIC companies rely on legal opinions that TIC's are real estate and not securities. Securities TIC's are sold only by the securities broker-dealers and not directly by the Sponsor. TIC's are generally considered as a possible replacement property by investors that have managed a property (the relinquished property), but are looking for less active management in their replacement property.***