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The 7 Keys to 1031 Exchanges

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PROPERTY TYPE

The first key is to note the difference between investment and personal property. Both types can be exchanged, but only for like-kind property. The IRS has chapters of confusing categories for personal property. Real property is land and those things permanently attached to it. Real property may be either personal or investment. Real property that you, a relative, or an agent have recently occupied may be considered personal property. Personal residential property is not investment property .

Any property that you have occupied as your primary residence will not qualify for tax deferral under Section 1031 until you have held it for investment or productive use in a business or trade. There are separate tax shelters for residential housing which are, in many ways, better than the breaks you get under Section 1031 for investment. property, A comparison of these is provided in a later chapter.

These two types of property, personal residence and investment, may not be exchanged for each other in a tax-deferred exchange.

Any land that you have held for investment or for productive use in a business or trade, and have not used recently for personal use, is considered held for investment and may be exchanged for any other land to be held for investment. Raw land is the same as a factory, is the same as an apartment, is the same as a rental house.

The IRS gets pretty particular when you are trading forms of ownership, and prohibits the trading of stocks, bonds, and interests in ownership of a company. Most of the things you can touch can be exchanged. A car for a car, a tractor for a tractor, a building for a building, a milkshake machine for a milkshake machine are all OK; but, you cannot trade a car for an airplane, nor a rental house for a business.

Section 1031 of the Internal Revenue Code allows for the exchange of non-owner occupied real property.

Second homes, vacation condos, and recreational lots are a special group that is in a gray area. They are considered personal property and not eligible for tax-deferred exchanges unless your personal use of them amounts to less than ten per cent of total time they were rented or less than fourteen days in a year. They will cause scrutiny by the tax auditor, so be careful. The burden of proof is on you.

Holding Period

The second issue concerns holding the property for investment or for productive use in a business or trade. The key here is how long you have held the property and how long you need to hold tile replacement property. Again, there is no definitive answer from the IRS, but some guidelines have been developed through IRS requests of Congress and through court cases, which, if followed, will provide considerable degree of safety. Most people have held their investment property for several years in a fee simple form.

In 1997 the law was changed to require a holding period of 18 months to qualify for exchanges. The property should be held for a full 18 months before it is actively marketed or any action is taken to convert the property to personal use. You can use this guideline on both ends, the relinquished property and the replacement property.

If relatives are involved, the timing is clear: two years. If either property transferred in an exchange involving relatives is disposed of within two years, the entire exchange is disqualified.

Related parties include not only brothers, sisters, parents, and lineal descendants, but C and S Corporation holders of more than 50%, corporate controlled members, 50% partner-to-partner attribution, and grantor of a fiduciary trust. Related parties must file form 8824 for two years following an exchange. Prohibited action by one related person will invalidate the tax deferral of the other party in a related party transaction. With relatives, specific language should be included to prevent the unilateral action of one from disqualifying the exchange benefits for the other.

An exception is made in the two year rule due to death, involuntary conversion, or for non-tax avoidance purposes (i.e.- exchanges of undivided interests in different properties so that the basis is not shifted and the taxpayer winds up with a larger or exclusive interest in any of the properties.) These exceptions mean see your mortician, the state, or your CPA.

FORM OF TITLE

The third key is the form in which you have held the title to the property. Fee simple ownership is the preferred form of ownership. Developers are specifically excluded, partnerships have to be very careful, and many states have forms of ownership of real property which are considered personal property. Companies may participate in the benefits of an exchange, but must meet the same criteria as individuals.

Several issues revolve around in what form the tile title is held. You may exchange a fee simple interest in real property. Most other types of fee interests may be exchanged, even defeasible or determinable in most cases. Likewise, leaseholds of thirty or more year's duration may be exchanged. Joint ventures are generally considered to be partnerships, which are discussed below. Joint tenancy is disqualified by definition.

DEALERS

If you buy and sell properties regularly, they are the product you sell, and you become a dealer. Dealers are not eligible to use Section 1031 for tax deferral. The IRS considers you no different than a company that buys and sells shoes or cars. The general rule is if you are involved in more than four transactions per year, you are probably a dealer.

Basically, a dealer is someone who holds property primarily for sale to customers in the ordinary course of a trade or business, such as a builder or developer. The Supreme Court has defined "primarily" to mean "of first importance" or "principally". An investor is "a passive owner of property, who holds property for its present income-producing potential. The state would consider this property an asset used in his trade or business..

The Court of appeals of the Ninth Circuit and the US Supreme Court identified eleven criteria which may establish you as a dealer:

- The purpose and use for which the property was acquired and used thereafter.
- The length of time between purchase and sale.
- The number and frequency of sales made over a period of time.
- The activity of the taxpayer and his agents and the developments and improvements made to put the property in salable condition, as, for example, platting, dedication of streets, etc.
- The activity of the taxpayer and his agents in advertising and otherwise promoting sales.
- The extent and substantiality of the above transactions, such as the time and effort devoted and the character and degree of supervision or control exercised by the taxpayer over any representative selling the property.
- Miscellaneous factors such as membership in a dealer organization" newspaper publicity, the nature of the taxpayer's business as shown in directory listings and tax returns, documents (such as the manner in which the land is recorded on books of account, corporate minutes, and resolutions} and use of a business office to sell the properties.
- The amount of gain derived from sales as compared to other income of the taxpayer, and whether the greater portion of this gain was attributable to appreciation in value over the period of ownership or was the result of the development and marketing activities of the taxpayer or his agents.
- The existence of a liquidation intent at the time of the sales.
- The activities of the taxpayer in purchasing, developing, and selling real properties before, during, and after the years of the sales in question.
- The replacement of the properties sold with additional real estate.
- The presence of some or all of these factors should result in the finding of dealer status. The absence of these factors should result in classification as an investor. (Brandenburger vs. US, And Malaat vs. US) Numbers 8, 3, and 2 have been considered the most significant factors.

PARTNERSHIPS

Partnerships are tricky. The partnership, as a partnership, may exchange properties. You may not exchange your partnership interest for an interest in another partnership. Thus, if you are holding investment property in a partnership, only the partnership may exchange the property .

What happens if the entire partnership does not want to relinquish a property and acquire the

same replacement property? In most states a partnership may roll out assets to the partners one time without taxation. Therefore, you may receive property from the partnership and exchange it for another partnership. Unfortunately, you may run into the problem of holding time. You must have been a general partner with all the rights and obligations of an individual property owner. Limited partners definitely do not qualify. You may not immediately contribute the property to another partnership. The IRS will collapse the transactions into one series and say you have traded interest in one partnership for interest in another partnership.. The two best strategies for exchanging out of a partnership are:

- Dissolve the partnership through a Section 761 election, distributing fee simple, undivided interests to the former partners, then hold the property for the required time period. Note All property held by the partnership must be converted.
- Buyout the non-exchanging partner and have the partnership complete the exchange.

When is a tenant in common or joint venture a partnership? The IRS has held that if a partnership agreement exists or partnership tax returns have been filed" the property is held as a partnership. If you have even acted like a partnership in your handling of checking accounts" sharing costs, or other financial arrangements" you may be considered a partnership. This is an area that needs to be reviewed closely by your CPA Of Enrolled Agent.

VALID EXCHANGE

The fourth issue is that an exchange take place. Exchanges differ from sale and purchase in several ways. The most important is the way the value is transferred. If the value is converted to cash which is available to the taxpayer, the IRS says the transaction cannot be distinguished from a sale and, thus, does not qualify as an exchange. For this reason, as much as any, facilitators came into existence.

- Property you own must be relinquished. You can retain some undivided interest less than 100% in the property you relinquished. You cannot hold the same interest which you reported to give up. You must have given up a fee interest. Even relinquishing an easement may qualify.
- Property you do not own must be acquired. You may not trade with yourself. Any transactions involving businesses in which you have an interest, partnerships, agents, or relatives **will be** scrutinized closely.
- The transactions must be related. The two transactions must be interrelated. If you are trading directly with someone else, property for property, and that is reflected in the title transfer, then there is clear documentation on relationship. If you are using a third party for facilitator, the documentation must be specific that one property is to be exchanged for like-kind property in the escrow instructions" tax affidavits" and facilitator agreement.. Merely having two transactions close simultaneously is not sufficient. They must reference each other in the documentation, or reference a common intermediary.
- You may not have constructive use of the funds at any time. Were you to sell your property and use the proceeds to acquire another property, it may seem like an exchange, but the IRS considers it two separate sales. The funds must be held by a third party under strict conditions. While you may take some funds out of escrow at closing which are taxable, you may not ask your facilitator to disperse additional funds until such time as the exchange is completed. Funds held in trust are not available for you to draw upon or use as collateral or receive any economic

benefit from, except the interest that grows within the account.

Funds may be held in a qualified escrow account or qualified trust account. Qualified refers to the fact that the exchanger may not have access to the funds.

PROPERTY VALUE

The fifth key is that the property acquired must be of equal or greater value. For the tax on the gain to be totally deferred, the entire equity and at least as much mortgage liability must be transferred from the relinquished property to the replacement property. If either equity or mortgage liability is less, you will be taxed on that amount or the amount of the gain, whichever is less.

Both the equity and mortgage liability must be equal or greater in the replacement property than they were in the relinquished property.. Cash or other property received when the replacement property is of lesser value than the relinquished property is called boot. Remember "For your property I'll give you these five acres and a horse to *boot*" If either equity or mortgage is less than the item it replaces, a tax is levied on the lesser of the gain or the boot received..

Lower mortgage liability is called mortgage relief. This is considered a benefit to the taxpayer and thus is taxed. You may contribute cash to the transaction and offset mortgage differences. You may not take cash and increase the mortgage. After the transaction is completed you may refinance the newly acquired property and take cash out. No time frame has been set for this series of transactions. It would be advisable to wait a year before refinancing. Remember that your new cost basis has been established, and the IRS will get its due in the long run.

Frequently used to illustrate this concept is the "napkin test," Allegedly originally written on a napkin, it allows you to quickly determine whether an exchange will qualify,

Boot is unlike property. In the terms of IRC 1031 boot is property not used for productive use in a trade or business or for an investment or unlike the property given up. Boot is taxed. Boot may be given or received. Boot is any property given or received in a tax-deferred exchange which does NOT qualify for non-recognition. This includes: CASH, A FREE LUNCH, A SACK OF PEANUTS, ASSUMPTION OF LIABILITIES, AND OTHER PROPERTY OR SERVICES WHICH DO NOT QUALIFY FOR NON- RECOGNITION. Gain to the EXCHANGER who receives boot is recognized (taxed) in an amount not to exceed the amount of boot received or the total gain, whichever is lesser. Loss is not recognized in an exchange.

TIME FRAME

The sixth key is that very specific time frames exist. This is the one area to which the IRS has given very good directions in the Regulations.

The Internal Revenue Service requires that qualified replacement property be unambiguously identified by the forty-fifth day after closing of the relinquished property. This designation shall be in the hands of the facilitator, and the receipt date of the designation must be duly noted.

Closing on one, several, or all of the designated properties shall be completed by the 180th day after closing. This means when it is recorded. These dates are not negotiable.

There are three ways to designate. They are separate categories, and you may choose the category most applicable to your situation.

- You may designate any three properties without restriction as to value or any requirement to acquire more than one of those designated. You may exchange for one" two" or all three. This is known as the three property rule.

“OR”

- You may designate any number of replacement properties as long as their aggregate fair market value does not exceed two times that of the relinquished property. You may acquire any number of these designated properties through this exchange. This is known as the 200% rule.

“OR”

- You may designate any number of properties of any value as long as you acquire 95% of all properties designated as part of this exchange. This is known as the 95% rule.

Most exchangers use the three property rule. Property acquired within the forty five day designation period is deemed to be properly designated.

Unambiguous designation means a street address, plat and lot or metes and bounds. The designation

“A lot on the north end of Bainbridge Island” would not qualify .

INTENT

The seventh key is that both form and intent count when you are trying to prove that you deserve to defer the taxes on a transaction. Facts and circumstances are critical to demonstrating an exchange, but you must also demonstrate that you were attempting to live within the intent of the Code and Regulations.

As With any investment, including real estate transactions, investors should always consult with a qualified tax advisor to obtain the best advice for their own particular situation.