

## The §1031 Exchange Opportunity

A §1031 Exchange is a transaction in which a taxpayer is allowed to sell one property and buy another. This can be done through a Simultaneous or Delayed §1031 Exchange. The transaction is authorized by §1031 of the Internal Revenue Code. It is the best strategy for the deferral of capital gains tax that would ordinarily arise from the sale of real estate held for investment or business purposes.

A successful exchange results in the taxpayer being able to utilize 100% of the proceeds from the sale of property to purchase a new property, thereby deferring the capital gains taxes and sometimes even more importantly, avoid the recapture of depreciation. Real Estate owners can accomplish virtually any investment objective with §1031 Exchanges including greater leverage, diversification, improved cash flow, geographic relocation, and/or property consolidation.

To avoid the payment of capital gain taxes the exchanger should follow three general rules:

1. Purchase replacement property that is the same or greater value as the relinquished property.
2. Reinvest all of the exchange equity into the replacement property.
3. Obtain the same or greater debt on the replacement property as on the relinquished property. The exchanger can offset the amount of debt obtained on the replacement property by putting the equivalent amount of additional cash into the exchange.

Section 1031 offers a number of opportunities because of its flexibility. Nevertheless, tax cases have consistently indicated that the required documentation (along with the procedures for implementing a deferred realty exchange) must be, in the words of the courts, "bulletproof" in order to avoid problems at an IRS audit.

### How Does It Work?

A §1031 exchange is usually a three-way delayed exchange, referred to as a "Starker Exchange", in which an intermediary is used to facilitate the transaction. There are four basic steps:

1. Seller arranges for sale of the "relinquished property" and includes exchange language in the contract.
2. At closing, sales proceeds go to a Qualified Intermediary for a §1031 Exchange.
3. Seller identifies potential exchange "replacement properties" within 45 days of closing on the relinquished property.
4. Seller completes the §1031 exchange within 180 days of closing on the relinquished property.

In a §1031 transaction, these steps can also occur simultaneously. Preferably before you sell your property, you need to consider what type of replacement property will work best for you, and whether or not you want to own a whole or partial interest in a property.

A Tenants In Common (TIC) §1031 Exchange allows property owners to exchange their management-intensive property for an institutional grade property with the potential to generate steady income, tax benefits and appreciation potential. The popularity of purchasing a partial Tenants In Common interest has been on the increase for several additional reasons.

Tax deferral under §1031 does not include any recapture of tax credits (e.g., low-income housing or rehabilitation credits) that may be applicable if the relinquished property being exchanged has not been held for the requisite holding period (15 years for the low-income housing credit).

## REQUIREMENTS FOR A QUALIFIED EXCHANGE

Section 1031 of the Internal Revenue Code lays out in detail the procedure and requirements for a tax-deferred exchange. It specifies that the properties must be held for investment or business purposes and that these properties being exchanged must be "like-kind," referring to the type of property being exchanged (real estate, personal property, etc.) and not its grade or quality. Qualifying property is broadly defined, for both the property being transferred and that received, as realty used for investment or business purposes.

In effect, all investment real estate, whether it is an office building or a vacant lot, can be exchanged to any other piece of investment property. Consequently, investment realty (held for either appreciation or rental) can be exchanged for real property used in a trade or business and vice versa. Partial realty interests such as conservation easements and perpetual mineral or oil rights are exchangeable with other types of realty (including a land contract in which equitable title has been transferred), or a lease with at least 30 years remaining (including renewal options) can be exchanged for a fee-simple interest in realty.

Note that personal residences are not eligible for a §1031 exchange. In addition, personal use realty may not be eligible. For vacation home §1031 exchange guidance, refer to IRS Revenue Procedure 2008-16 which creates a safe harbor definition. When a mixed-use exchange involving realty with both qualifying and personal usages (such as an operating farm with a personal residence eligible for IRC section 121) exists, these different usages should be addressed through contractual allocations of the price.

The tax code also lists items that are not considered "like-kind". These include:

- Stock in trade or other property held primarily for sale (e.g. dealer property)
- Stocks, bonds, or notes
- Other securities or evidences or indebtedness
- Interests in a partnership
- Certificates of trusts or beneficial interest
- Partnership interests

In addition, the Code was amended in 1989 specifying that property outside the United States or its territories is non-qualified as "like-kind".

### Role of the Qualified Intermediary

Section 1031 describes the need of a "safe harbor," such as a Qualified Intermediary (QI), to facilitate the exchange. The exchanger must not have "Constructive Receipt" of the sale proceeds – no cash or other benefits can go to the exchanger;

If an exchanger actually or constructively receives non-like-kind property known as boot (e.g., money or personal property) for the relinquished realty anytime before receiving the like-kind replacement property, the transaction is a sale and not a deferred exchange. As a result, the structuring of a deferred real property exchange requires documentation to support an interdependent and integrated transaction with the sale proceeds not being paid to the exchanger at the settlement date (or held in escrow).

The paper trail for this documentation should begin with the original purchase and sale agreement, which could contain a clause such as:

*"Buyer hereby acknowledges that it is the intent of the Seller to effect an IRC §1031 tax deferred exchange which will not delay the closing or cause additional expenses to the Buyer. The Seller's rights under this agreement may be assigned to a Qualified Intermediary, named by Seller, for the purpose of completing such an exchange. Buyer agrees to cooperate with the Seller and the Qualified Investor in a manner necessary to complete the Exchange."*

The QI is an entity or individual independent of the exchanger and not deemed to be its agent, either objectively or subjectively. Under the objective test, the QI cannot be the taxpayer's closing attorney or anyone else who has had a business relationship with the exchanger during the last two years.

The QI is the recipient of the net proceeds from the closing of the relinquished property, with the money impounded for subsequent reinvestment into other realty. Any earnings on these monies may not be paid to the exchanger until the end of the exchange.

In a three-party deferred exchange, the QI is the third party, with the other two being the exchanger and the replacement property owner. These relationships are defined in the required documentation, executed with the relinquished property buyer's cooperation because of contractual language described above. These documents would include notice to the parties of the use of direct deed, in which the exchanger would deed the realty being disposed directly to the buyer, while the replacement property owner's deed would name the exchanging taxpayer as the grantee. The QI would not need to take legal title to the realty being relinquished or exchanged.

IRS Revenue Ruling 2002-83 prohibits a QI from using the impounded funds to acquire the property of a party related to the exchanger to be used as the replacement realty. Such a disposition by the related party would be deemed a sale under IRC 1031(f), precluding any party from cashing out during the two-year period following the exchange.

The code also sets a strict timeline for the completion of an exchange. This timeline will be discussed in greater detail later.

### Three Exchange Options

Here, we will discuss three different ways of completing a 1031 exchange. These three options are:

**Simultaneous Exchange:** properties are transferred concurrently, having to close at the same time in order to avoid constructive receipt of the sale proceeds.

**Reverse Exchange:** only recently approved by the IRS for 1031 exchange purposes, this exchange method allows the exchanger to purchase the replacement property before the relinquishing property is closed. This process involves the formation of a single purpose limited liability company, called the "Holding Entity", which takes possession of the replacement property until such time as the relinquished property is closed (referred to as "parking" the property.) This transaction must be completed within 180 days of closing on the replacement property. *Reverse exchanges can be complicated. It is highly recommended that the taxpayer seek additional professional tax and legal advice.*

**Delayed (or Starker) Exchange:** the most commonly used method of performing a 1031 exchange, this option allows the exchanger to close on the relinquished property before closing on the replacement property. Before the relinquished property is sold, the intention of completing a 1031 exchange with the property must be declared, and an exchange agreement must be made between the exchanger and a qualified intermediary (QI).

- Delayed exchanges must be completed within strict time limits with absolutely no extensions. The exchanger has 45 days from the date the relinquished property closes to "Identify" potential replacement properties. This involves a written notification to the Qualified Intermediary listing the addresses or legal descriptions of the potential replacement properties.
- Once the Identification period is completed, the exchanger has the remainder of the 180 days (beginning with the closing of the relinquished property) to close on at least one of the identified properties. If the exchanger fails to close within this time period, then the exchange is busted and the exchanger must pay the capital gains tax.

### Identification of Replacement Property

There are three ways to identify properties the exchanger wishes to purchase. By far, the most common is the "3-property" rule. In this rule, the identification period begins with the sale of the relinquished property and gives the exchanger 45 days to identify up to 3 possible investment properties. If the exchanger has no possible exchange properties at the end of this 45 day time period, or the properties that were identified are no longer available, then the exchange is busted and the exchanger must pay the capital gains tax.

Replacement property is identified if it is —

- identified in a written agreement (preferably executed with the QI subsequent to the initial transfer date) using a portion of the impounded funds for the earnest money deposit; or
- designated as replacement property in a written document signed by the exchanger and hand-delivered, mailed, faxed, or otherwise received by the QI before the end of the identification period. The property ultimately acquired must be substantially the same as that identified. For example, if two acres are identified, at least 75% of the acreage must be purchased as replacement property.

The regulations permit more than one property to be identified as replacement property. The maximum number of replacement properties which the exchanger may identify under the regulations is as follows:

- Three properties of any fair market value (FMV); or
- Any number of properties, as long as the aggregate FMV of all properties identified as of the end of the identification period does not exceed 200% of the aggregate FMV of all relinquished properties as of the date of transfer; or
- Under the 95% rule, an exchanger is permitted to identify any number of properties of any total value, provided that 95% of what has been identified is actually acquired within the 180-day replacement period.

Replacement property acquired during the 45-day period reduces the number of properties that can be identified under the above rules.

**BE SURE TO CONSULT YOUR OWN LEGAL OR TAX ADVISOR**

*The exchanger is always advised to discuss the intended exchange with their legal or tax advisor*

## Selecting Real Estate Brokers

Let's be honest here for just a minute. Property owners often look askance at real estate brokers, largely because they feel that they are going to be SOLD into a situation that only benefits the broker. Essentially, the broker's motives are suspect until proven otherwise.

This is often combined with a common perception that all a broker brings to the table is market knowledge and access to multiple listing services. In reality, a knowledgeable real estate broker can bring a great deal of valuable expertise to the transaction, especially those in which the seller is contemplating a §1031 exchange.

In addition, the broker selection process can be daunting to a prospective seller. Choosing the "right" broker is a critical decision not to be taken lightly. All brokers are not created equal and commercial investment real estate, because of its complexity, requires specialization.

The approach to the broker selection process taken by *The Center For Commercial Real Estate (CFCRE)* is much different in that we know exactly what attributes are required in a given situation and can quickly identify a quality broker who will give you full value for the commission dollars earned. This is true in any market, large or small, nationwide... and it costs you nothing! Zip, nada, 100% free to you.

In every case, *CFCRE* will screen the available brokers and then select the best agent for the task at hand. Since we have no allegiance with any one broker or brokerage organization, we have the freedom to make a selection based solely on knowledge, experience and ability. In San Francisco we recently chose an agent with Cushman & Wakefield while in Winter Park, Florida, it was an agent with CB Richard Ellis. In other cases, the best agent has been one who operates independently or is associated with a regional brokerage company.

**In every case, we remain the primary contact until we are confident that the client's interests are going to be well served.**

Have we ever made a bad selection? Of course, but it has always become obvious during the initial stages and since we always identify an alternate broker that we can turn to should things not go as planned, the remedy has always been swift and effective. This is precisely why we stay involved through the initial stages and then remain loosely in the loop until the client's requirement has been fully satisfied.

As noted above, our efforts are paid for by the broker who is ultimately selected, as a referral fee from the commission earned. It doesn't matter which broker is selected, all of them are willing to pay such a referral fee and it is a normal and customary way of doing business within the industry. The important thing is that our judgment is not influenced in any way since we will be paid the same referral fee no matter which broker is selected.

If you are interested in putting our broker selection process to work for you, please contact us so that our team can get started immediately!

We would invite you to discuss your specific needs with Steve Wennerstrom, a Registered Representative with Pacific West Securities, Inc. and 25-year veteran of the commercial real estate industry. He will be happy to answer your questions and provide you with the information you need to consider a §1031 Tenant-In-Common Exchange.



**STEVEN M. WENNERSTROM**  
Registered Representative

*§1031 Tax Deferred Exchange Solutions*

Direct: (303) 489-4013 • Fax: (303) 325-3179 • Toll-Free: (866) 359-6465  
[www.1031exchange-tic.com](http://www.1031exchange-tic.com) • [stevewennerstrom@pwfinancial.net](mailto:stevewennerstrom@pwfinancial.net)

Securities offered through Pacific West Securities, Inc., Member FINRA/SIPC