# UNDERSTANDING THE BASICS

# 1031 EXCHANGE

PREPARED BY

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# 1031 EXCHANGE WHAT YOU MUST KNOW

1031 exchange is a complicated transaction with many rules and critical deadlines that must be followed.

Every day we see exchanges destined to fail. In the following, you will learn how to avoid these mistakes and the basics in 1031 exchange.

This report has three sections:

1) 1031 the basics - rules you can not break.

2) Grey areas - rules that invite risk, but are not clear.

3) What decisions you need to make now.

# THE BASICS

## FOLLOWING THESE RULES IS A MUST

You need a qualified intermediary.

A qualified intermediary takes possession of the funds from your sale and holds them until you make your next investment.

***Do not take possession of the proceeds of your exchange***.

You can not change the entity your property is held in (there are certain exceptions to this rule such as single member limited liability companies and fully revocable grantor trusts).

Understand what expenses are exchange permissible selling expenses.  Non-permissible selling expenses could be though of as "boot" in your exchange.  Boot amount are taxable.

Structure your closing statement and sale to account for non-permissible.

**90%**

**ACCORDING TO A RECENT STUDY, 90% PLUS OF 1031 EXCHANGERS END UP PAYING THE TAX EVENTUALLY**

# 1031 Exchange Timeline

Tax code that allows the sale and exchange of investment property and deferral of tax

DAY 45

DAY 180

### Sell Your Property

Sale proceeds go to QI (you cannot take possession of funds).
QI holds funds in escrow.

### Identify Property

List up to 3 properties or 200% rule or 95% rule.
Debt / equity must be equal or greater

### Close on Replacement Property Close Exchange

QI sends funds to close on property.
Investor keeps 100% of capital; tax is deferred.

**Timeline is critical. You have 45 days from the close to identify, 180 days to close.**

## There are three ways to identify:

1) 3 property rule. Identify three properties, acquire any one or combination of properties.

2) 200% rule. Acquire up to 200% of the market value (less expenses). Any number of properties.

3) 95% rule. Rarely used. Can ID any number of properties, must close on at least 95% of the market value.

**Don't Forget - Reinvestment Requirement**

You must purchase the same market value as what you sold. This means recreating the equity and debt position.

You can always do a partial exchange, but you will owe some tax. You can always bring cash to the exchange to reduce the debt you need to acquire.


## MOST OF THE RULES ARE CLEAR SOME ARE NOT

**The 200% Rule**

There is very little guidance on what needs to be closed on when using the 200% rule.  Some say you can acquire whatever you like, when others guide you to stick very close to what you identified.

The key is to reduce audit risk.  Have a plan before coming to your exchange about what you want to close on.

**Intent**

Your intent in performing a 1031 exchange must be to hold the property for investment purposes.  However, the IRS gives us no guidance on how long this must be your intent or how to prove intent.  Best practice is to document your intent with your CPA on your properties.

# 1031 DECISIONS YOU MUST MAKE

## Plan

Have a plan of attack for your exchange before you sell your property.  Discuss with your CPA your potential tax liability, select a qualified intermediary to work with and gain a general sense of what you plan to do for your next property.

## Have a replacement property backup plan

There are many like-kind property types eligible for exchange: single family, multi-family, commercial office, retail, industrial, vacant land, oil and gas interest, mineral interests, air and water rights and fractional ownership (DST or TIC).


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