



# Busting 1031 Exchange Myths

## Avoid Costly Mistakes

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# What is a 1031 Exchange?

Tax deferred exchanges have been part of the Tax Code in one form or another since 1921, many people are not aware of this powerful tax benefit.

In general, an I.R.C. §1031 Exchange allows owners of business or investment real estate to defer the recognition of all or most of the capital gains taxes and depreciation recapture - normally due upon the sale of the property.

So long as they use the proceeds to buy replacement business or investment real estate, within 180 days.



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# Why Use 1031 Exchange?

Purpose: Defer payment of capital gains taxes

An Exchange is a tax strategy that with proper planning, can be utilized to reduce tax liability, preserve equity, increase purchasing power, and increase annual returns. Often people think about Exchanges only in conjunction with commercial or industrial property, there is a strong use for Exchanges when dealing with residential properties as well.

There are structures that allow Exchangers to purchase vacation homes, retirement homes, and under some very special circumstances, the ability to combine an Exchange with a primary residence.





## 1031 Exchange Misconceptions

There are many misconceptions surrounding 1031 exchanges due to their complex nature and the specific rules and regulations that govern them.

Let's look at most common reasons for these misunderstandings.



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## Complexity of the Rules

The Internal Revenue Code Section 1031 has specific requirements regarding timelines

- 45-day identification period
- 180-day exchange period
- Like-kind property
- Reinvestment of all proceeds
- Use of a Qualified Intermediary (QI)

These rules can be intricate and are often misinterpreted.

## My Attorney or CPA Can Always Act as QI

While these professionals are crucial in the exchange process, they cannot act as your QI if they have provided certain non-exchange-related services to you within the two years prior to the exchange.

This is to ensure the QI remains a neutral third party.





## Like-Kind

means I must exchange the same type of property, such as apartment building for apartment building.

A common misconception is that "like-kind" means the exchanged properties must be the same type..

**In reality, "like-kind" refers to the nature of the investment, meaning most real properties held for business or investment purposes are considered like-kind.** You can exchange a rental house for a commercial building or even raw land.



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# What is Like-Kind?



- Vacant Land for single family home
- Apartment building for a retail center
- Office building for a warehouse
- 4-plex for a TIC interest in an office building



# What is **Not Like-Kind?**



- Primary residence
- Vacation home/Second home
- Dealer/Developer property- Homebuilder/Flipper
- Personal property
  - LLC/Partnership Interest
  - Cars/RVs, planes, art, etc.



# I must literally “swap” my property with another investor.

- No. A 1031 exchange allows you to sell your relinquished property to one party and purchase replacement property from another party at a later date, provided you comply with all of the rules.
- Although there are a few issues regarding sales and purchases between related parties,
- most Exchanges are structured not unlike any other typical sale and subsequent purchase
- in most cases an Exchanger has an even greater need for a realtor due to the time constraints placed on Exchangers.
- Simply put, an Exchange is a sale, just like any other sale, and a purchase just like any other purchase, but with some additional rules, time deadlines, and the involvement of a Qualified Intermediary.





I only need to invest my net proceeds

**FULLY DEFERRED EXCHANGE:** to have a fully deferred exchange. Generally:

- 1) Taxpayer must buy replacement property(ies) of greater or equal value of sale property price.
- 2) Taxpayer must reinvest all proceeds from the sale of the relinquished property(ies)
- 3) Taxpayer must re-acquire debt equal or greater to debt paid off from the relinquished property (or replace the debt with additional cash)



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# Financial Considerations

To be fully tax-deferred the exchange must be:

- Equal Or Greater in VALUE
- Equal Or Greater in EQUITY (must invest all net proceeds in the exchange)

*Cash can be added to offset debt on a dollar-for-dollar basis*



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## Misconceptions About Reinvesting All Proceeds

A taxpayer can choose to take some money out when the relinquished property closes, but it is considered boot and will be subject to federal and state taxes

Buy a replacement property of a lesser value



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# Financial Considerations

Exchanging for equal value but reduced equity

## Cash Boot

Relinquished Prop.

Value: \$300,000

Loan: \$100,000

Equity: \$200,000

Replacement Prop.

Value: \$300,000

Loan: \$150,000

Equity: \$150,000

**Boot: \$50,000**



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# Financial Considerations

Exchanging up in value, but equal equity

## No Boot

Relinquished Prop.

Value: \$300,000

Loan: \$100,000

Equity: \$200,000

Replacement Prop.

Value: \$400,000

Loan: \$200,000

Equity: \$200,000



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# Tax Avoidance vs Tax Deferral

It's important to understand that a 1031 exchange is a tax deferral strategy, not a tax elimination. The capital gains taxes are postponed until you eventually sell the replacement property without doing another exchange.



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## Primary Residences and Vacation Homes:

There's confusion about whether primary residences or vacation homes qualify for 1031 exchanges. Generally, a primary residence does not qualify as it's not held for business or investment. Vacation homes can qualify, but strict rules regarding rental periods and personal use must be followed.



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# The sale and purchase must take place simultaneously.

The taxpayer has 45 days to identify the new replacement property and 180 days to close



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# Timeframes

When does my 1031 clock start?



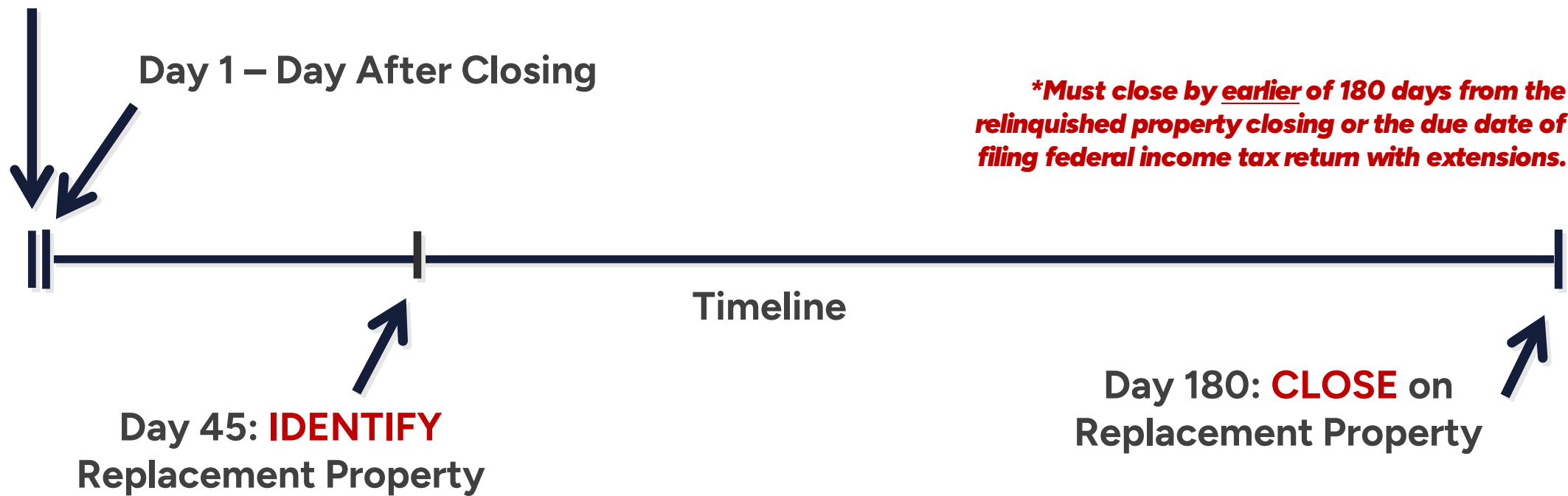
# Timeframes for an Exchange



Day 0 – Closing of Relinquished Property

Day 1 – Day After Closing

**\*Must close by earlier of 180 days from the relinquished property closing or the due date of filing federal income tax return with extensions.**



**No extensions – even if deadline is a Saturday, Sunday or a legal holiday.**

# Identification Rules



## Identification Types

- Three Property Rule
- 200% Rule
- 95% Rule

## Five Requirements of the Identification:

- 1) In writing
- 2) Signed
- 3) Sent to a party to the exchange (QI)
- 4) Within 45 days and
- 5) Unambiguous

# Identification Form 3-Property Rule



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### 3 PROPERTY RULE - REPLACEMENT PROPERTY IDENTIFICATION FORM

Exchange No.:	Deadline:	Relinquished Property Address:
537205		123 Main Street, My Town, AZ

- Replacement Property must be unambiguously described by means of a street address (including unit #, if applicable), legal description, or distinguishable name.
- No changes can be made to the identified properties after the expiration of the 45-day identification period. Only properties properly identified within the 45-day identification period will be eligible for tax deferral treatment.
- If you will not be acquiring 100% of the ownership interest, please enter the approximate ownership interest to be acquired.
- If you will not be buying equal or greater value than what you sold for, please contact us immediately to review your options.
- If improvements will be made on a replacement property during the exchange period, please attach a detailed description of the improvements. (Special arrangements must be made if you intend to use exchange funds to make improvements. In that event, please contact us immediately to review your options.)
- This Identification Form must be signed and sent to First American Exchange (or any other party to the exchange other than a disqualified person), on or before the deadline specified above.

**NOTE:** If you want to identify more than three replacement properties, please contact us for further instructions.

#### Property Description

#### Ownership

Street Address (Unit #, if applicable)	City	State	Zip	%

*The undersigned hereby identifies the foregoing properties as replacement property for the above referenced tax-deferred exchange as required by Internal Revenue Code § 1031(a)(3)(A) and Treas. Reg. § 1.1031(k)-1(c). I understand that after the 45-day identification period, my exchange funds can only be used to acquire properties identified on this form. Any remaining funds will be disbursed to me only after: 1) All of the properties on this list have been acquired, (or if specifically indicated, the number of properties specified) or 2) the expiration of the 180 day exchange period.*

\_\_\_\_\_  
John Doe

Date: \_\_\_\_\_



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# Identification Period



Day 1

Day 45



- Within the 45-day window, an exchanger may revoke their identification and submit a new one as many times as desired, however, no changes may be made after the 45<sup>th</sup> day.
- Any properties acquired as part of the exchange must be listed on the most current identification form



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# SAME TAXPAYER REQUIREMENT

I'm married now  
We have a LLC with multiple partners



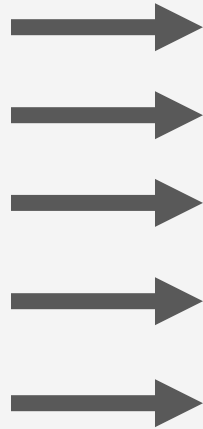
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# Same Taxpayer Requirement

Same taxpayer must complete the exchange

## Relinquished Property

- ABC Partnership
- XYZ Corporation
- The Wilson Revocable Trust
- Mary Jones
- John Smith 100% Ownership



## Replacement Property

- ABC Partnership
- XYZ Corporation
- Rick and Sue Wilson as individuals
- Sole member of the Jones LLC
- John Smith 20% TIC Ownership





# Same Taxpayer Requirement

**Same taxpayer who transfers relinquished property must acquire replacement property.**

## **Favorable exceptions:**

- Disregarded single-member LLC and the sole member
- Grantor and his grantor/revocable/living trust



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- Partnership is separate taxpayer
- Partnership sells, partnership buys
- Individual partners
  - Can't trade partnership interest
  - Drop and swaps

## Who Can Exchange?



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# I must hold property longer than a year before exchanging it.

The 1031 regulations do not list a time requirement on how long you must hold property, but it does say that property must be **“held for productive use in a trade or business or for investment.”** Holding property longer helps prove your intent to hold it for investment purposes rather than for sale.



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**I just need to file a form with the IRS with my tax return and “roll over” the proceeds into a new investment.**

**No.**

A valid exchange requires much more than just reporting the transaction on Form 8824. The taxpayer must sign exchange documents before the closing and cannot touch the exchange proceeds.



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# 1031 exchanges are just for big investors.

**No.** Anyone owning investment property with a market value greater than its adjusted basis should consider a 1031 exchange.



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# The Four Cornerstones of Exchange

## Same Taxpayer

- Taxpayer sells = Taxpayer buys

## Like-Kind Property

- Real estate held for investment or business use qualifies

## Deadlines

- 45-day identification rule and 180-day exchange period

## Maximum Benefit- Financial Analysis

- To defer all tax and depreciation recapture, exchanger must buy replacement property for, or above, the amount of the sale price of the relinquished property



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# Exchange Process

- Document Preparation (and necessary information)
- Sign exchange documents on or before closing (no close, no fee)- DocuSign?
- Qualified intermediary holds funds
  - Taxpayer can't control funds/Earnest \$ is okay/Inspection?
  - Taking boot out at closing/Other transactional expenses
  - Funds held in a separate bank account
  - QI Fee deducted from held funds (not on SS)





# Questions?

# Thank you for attending!

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# Questions?

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