

# SECTION **1031** EXCHANGE HANDBOOK

**YOUR QUESTIONS ANSWERED**



**Investment Exchange Group** 

**Toll free 800.908.1031**

[www.ixg1031.com](http://www.ixg1031.com)

# Investment Exchange Group



This 1031 Exchange Handbook will simplify and clarify terminology common in the industry.

The next time you or your client asks the question, “Can I do a 1031 Exchange?” you will have a quick reference guide. Title requirements, exchange wording, and explanations of reverse, construction and improvement exchanges are all covered in this handbook.

Investment Exchange Group, LLC (IXG) is a nation-wide qualified intermediary specializing in all types of 1031 tax deferred exchanges. Our team of professional consultants will prepare the documents necessary to complete your exchange and properly comply with current Section 1031 tax law.

IXG maintains a \$5 million fidelity bond. Our CPAs and attorneys, real estate, banking and title professionals offer you the protection and assurance you need to complete an exchange.

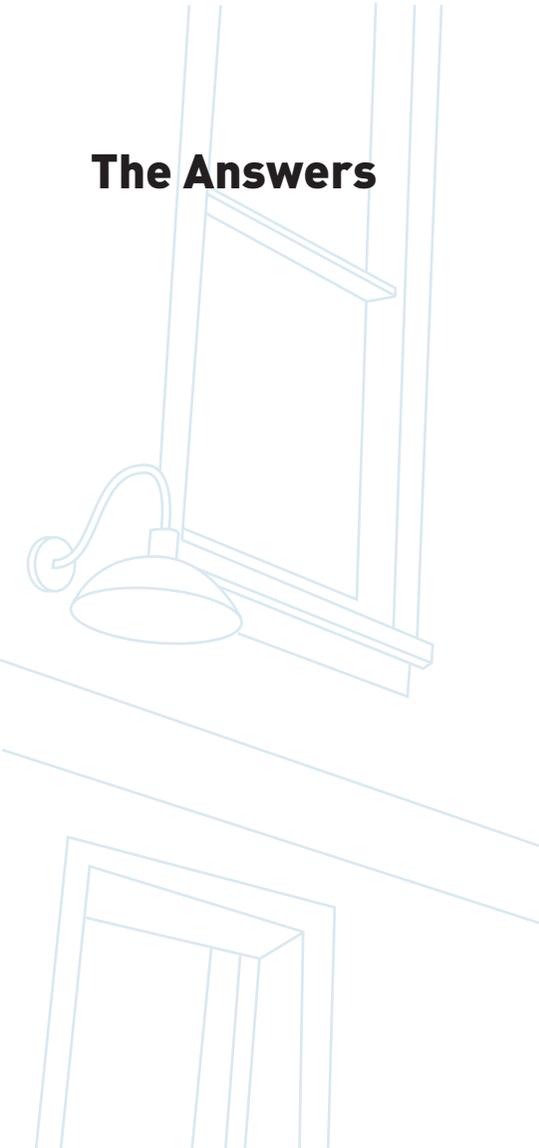
At Investment Exchange Group, we are dedicated to providing you with exceptional planning and assistance during your exchange.

# The Questions

## How to determine whether your real estate sale could be a 1031 Exchange:

1. **What did you do with the property you are selling?** Did you rent it out, run your business out of it, lease it, or is it raw land? As long as it is not your primary residence, it is a viable 1031 property.
2. **What are you going to do with the money resulting from the sale?** If you want to reinvest in real estate, your new property will most likely qualify for a 1031 Exchange.

# The Answers

A line art illustration of a window with a lamp and a door frame. The lamp is a simple, rounded, dome-shaped lamp with a curved neck, positioned below the window. The window has a frame and a sill. Below the window, there is a door frame with a handle. The entire illustration is composed of thin, light blue lines.

1. Like-kind Property

2. The 45-day Identification Rule

3. The 180-day Rule

4. Qualified Intermediary

5. Title Requirements

6. Equal or Up Investment

**GO STRAIGHT TO THE SECTION BY  
CLICKING ON THE BUTTONS ABOVE**

## Like-kind property

The first requirement for a 1031 Exchange is that both the property to be sold and the new property be like-kind. This is one of the most misunderstood concepts in 1031 Exchanges. Like-kind relates to the use of the properties. Any property used to produce income qualifies as like-kind to other income-producing property. You can sell a rental duplex to buy a ranch. You can sell a warehouse and buy a condo. In addition, raw land will always qualify for 1031 treatment whether or not you had it leased. Like-kind relates to use, not the description or the location of the property. In general, it makes no difference what the use was, as long as it wasn't your primary residence.

### Example 1

Sam and Jane own a duplex they bought in 1982 and have rented out to various tenants ever since. They want to sell it and buy a condo at the beach to rent out to others and use a little bit themselves.

- Does this qualify for a 1031 Exchange?  
**Yes.** Both properties are held for income or investment purposes.

### Example 2

Joe owns a barber shop business, but he only leases the building which houses his business. He wants to retire and sell his business and buy a cabin in the mountains with the proceeds.

- Can he do a 1031 Exchange?  
**No.** Because Joe does not own the real estate, he cannot do a 1031 Exchange by selling his business (which is not real estate) and buying real estate to replace it.

### Example 3

James, a dentist, owns an office building that he leases to other dentists.

- Can he exchange the building for a piece of raw land on which to build an apartment building?  
**Yes.** Investment property can always be exchanged for raw land held for income or investment purposes.

## The 45-day Identification Rule

The Internal Revenue Code requires that you identify your potential new (replacement) properties within 45 days of the closing on the sale of the old property. The 45 days are calendar days, so if the 45th day is Sunday, Christmas, or the 4th of July, that day is still the deadline for identification of new properties. There are no extensions allowed. There are two ways to comply with the 45-day identification requirement. The first way is to have already purchased your new property. If you use all your money from the sale (your exchange proceeds), your exchange is complete at that point.

In the event you haven't closed on a new property and spent all the money within 45 days, you must identify your new property. By midnight of the 45th day, you must compile a list of properties that you're thinking about purchasing to replace the property you just sold. The list must be specific: it must show the property address, the legal description, or other means of specific identification. This identification list must be presented to your qualified intermediary before the deadline.

Notification forms and follow-up are provided by IXG.

You can identify up to three potential new properties without regard to their cost. If you wish to identify more than three potential replacements, however, the IRS requires that the total value of everything identified be less than double the value of the property you sold. This is called the 200% rule. You may identify more than three possible replacements, but be aware of the 200% rule.

### **Example 1**

Bev sells her old property for \$100,000 on January 1. She may identify up to three new properties of any value within 45 calendar days of January 1.

### **Example 2**

Bev wants to identify four potential new properties: four condominiums selling for \$75,000 each.

→ Is this ok?

**No.** The four properties identified exceed 200% of the value of the property sold.

## The 180-day Rule

Section 1031 requires that you purchase one or more of the new properties by the 180th day after the closing of the old property. You must purchase one or more properties listed on your 45-day identification list. You cannot buy a new property not listed.

### **Example 1**

Brad identified a condo under construction within 45 days of his sale, but now the builder tells him it won't be completed and ready to close within the 180 day period. If Brad cannot close within 180 days, his exchange will fail.

## Qualified Intermediary

The fourth requirement of Section 1031 Exchanges is that you must use a Qualified Intermediary (QI). The QI cannot be someone with whom you have had a business or family relationship. Thus, for example, your attorney, accountant, or brother are all disqualified. You must use an independent organization whose only contact with you is to serve as the QI. The QI prepares the exchange documents, holds the cash proceeds from the sale, and should answer any questions you may have during the exchange. The QI must hold your proceeds from the sale of the property in order to have the transaction qualify as a 1031 Exchange. If you have actual or even constructive possession of the proceeds (i.e., control of the money without actual possession), the transaction is taxable to you. If and when you determine that you want to undertake a 1031 Exchange, you must involve the QI prior to the closing on your sale property.

## Title Requirements

Section 1031 requires that the taxpayer on the old property be the same taxpayer on the new property. Examples of entities holding property are trusts, corporations, partnerships and LLCs. If XYZ partnership is in title to the old property, XYZ partnership must take title to the new property. If you and your spouse hold title to the old property, you and your spouse must take title to the new property.

### Example 1

Bob owns an apartment building in his own name, but wants to buy a new property to be held in the name of a new corporation he wants to set up.

- Can he do this?  
**No.** He must acquire the new property in his own name to complete his exchange.

### Example 2

Pete, who is married to Margaret, owns a duplex that is titled in his name alone.

- Can he title the new property in his and Margaret's name?  
**No.** Pete must first complete his exchange in his own name. He may then quitclaim his interest to himself and Margaret as joint tenants after the exchange is complete. In the alternative, he may take an undivided interest in the property (i.e., Pete as to an undivided 50% interest) to complete his exchange, and Margaret can take the other 50% interest. This will only work if Pete's purchase of the 50% interest will allow him to spend all his exchange proceeds and trade equal or up in value.

## Equal or Up Investment

The last rule under Section 1031 is that in order to defer 100% of the taxes on your gain on the sale of the old property, you must buy equal or up. There are two aspects of the equal or up rule. First, you must reinvest all of the cash that is generated from the sale of the old property. Second, you have to buy a property (or properties) that has a sale price equal to or greater than the net sale price of the property you sold. In calculating the equal or up number, there are two items to keep in mind. **The first is debt relief.** The amount of money used to pay off debt against the property attributable to first mortgages, second mortgages, etc. is debt relief. **The second is cash.** The amount of debt relief, plus the amount of cash that would otherwise come to you as seller, is the target replacement value that you need to reinvest to defer 100% of the taxes.

Can you take money out of the deal at closing? Yes. This money (called boot by the IRS) is taxable, but can be taken out of the exchange without invalidating the rest of the exchange, if the exchange documentation so provides.

### **Example 1.**

Pete owns a property he is selling for \$200,000. He has a \$75,000 mortgage against the property. He wants to buy a new property for \$125,000 with the cash.

- Is this a fully tax deferred exchange?  
**No.** Pete is buying down from \$200,000 to \$125,000. Pete owes tax on the amount of the buy down, (i.e., \$75,000).

### **Example 2**

As in the example above, Pete decides to buy a property for \$250,000 by getting a loan for \$150,000 and using \$100,000 of the \$125,000 cash the QI is holding.

- Is this exchange fully tax deferred?  
**No.** Pete did not use all the cash.

# How to Select a Qualified Intermediary

There are no licensing requirements for QIs, and few regulations on who can serve as one. Therefore, it is crucial to select a QI with professional credentials and extensive experience.

## Documentation

The QI is responsible for putting the documentation in place to qualify your transaction as a 1031 Exchange. That documentation must be in place before the closing on the sale property. There are typically three documents the QI will provide: the exchange agreement, an assignment, and a notice.

The exchange agreement is a contract between you and the QI that sets out the rules you must follow in order to complete the 1031 Exchange.

The assignment of the sales contract to the QI must also be in place. This is because, theoretically, the Qualified Intermediary steps into your shoes and sells the property for you. Remember that you cannot have control of the proceeds or the actual receipt of the money. The assignment allows the QI to receive the proceeds for you.

The third document the QI will provide is a notice to the party on the other side of the transaction advising that the transaction is a 1031 Exchange. The purpose of notification to the other party is to prove that the exchange was in place at closing.

## **Security of Funds**

Insist that your QI is bonded for exchange transactions for at least \$5 million per transaction. In addition, your QI should pay you interest on your proceeds while the QI holds them.

## **Member of FEA**

Verify they are active members of the Federation of Exchange Accomodators (FEA), the only national organization for Qualified Intermediaries.

## **Professionalism**

Expect your QI to answer questions about your exchange at no charge to you. Your QI should have real estate, tax, and legal professionals on staff, ready and able to answer even the most complex 1031 questions. Questions to ask of a prospective QI include:

### **Does the QI stand behind their exchanges?**

Ask the prospective QI if they will make you sign a hold harmless agreement that says you cannot sue them if they make a mistake that results in your exchange being disallowed. If they require that you sign such an agreement, and many do, find a different QI.

### **Does your QI provide audit protection?**

What happens if your exchange is audited? Section 1031 is a complicated code section with many exacting and detailed requirements. Will your QI help you navigate your way through an audit? If so, are they willing to document their commitment in writing? Is there any cost for this audit protection?

### **How are the QI's fees structured?**

Many QIs charge a front-end fee when you sell your old property and an additional back-end fee when you buy your new property. Some also charge an additional set-up fee and some charge a monthly holding fee. You may only be quoted the front-end fee when you inquire. Make sure you understand the total costs of your exchange.

**Who earns interest on the exchange funds?**

In most cases, it is the QI. Remember to factor the interest earned by the money into the transaction when you calculate the total exchange cost. If you earn the interest, make sure that you begin to earn interest the moment your funds hit the QI's account.

# An Exchange Timeline

## Phase I: Sale of Old (Relinquished) Property

### A. Contract Stage

1. Negotiate and sign your contract as seller.
2. Include language in your contract to establish your intent to do a tax deferred exchange:  
“Seller intends to do a 1031 Exchange and buyer agrees to cooperate with seller regarding the exchange at no additional cost to seller and no delay to the closing.”  
(The Colorado Real Estate Commission requires an additional form.)
3. Select a title company and/or closing agent to handle the closing of your transaction.

### B. Closing Stage

1. Call IXG when you have a signed contract. Information we need:

- Phone number, name, and reference number for your closing agent or title company and a copy of your contract
  - Your mailing address, phone and fax numbers
  - Sale price of the property you are selling
  - Amount of any debt on the property you are selling
  - Percentage of ownership of the property you are selling (i.e., if you own half of the property)
  - Whether you are going to help the buyer of your property finance the purchase (i.e., owner carry)
  - In what name you hold title to the property
  - If you need any cash out of the transaction (This amount will be taxable boot to you).
2. IXG will contact the closing agent or title company and will prepare the exchange agreement between you as an Exchanger and IXG.

3. The exchange agreement will be forwarded to you or to the closing agent, depending on timing and the location of the closing. Draft copies of the exchange agreement may be forwarded to you if time allows.
4. If possible, a representative of IXG will be present at closing to obtain signatures on the exchange agreement and other documents. If an IXG representative is not able to attend, the closing agent will obtain these signatures.
5. The sale closes, and funds from the sale are wired or delivered via check into your exchange account with IXG.

## **Phase II: Purchase of the New (Replacement) Property**

### **A. Identification Stage**

1. You have exactly 45 days (including Sundays and holidays) from the closing

- of the old property to identify up to three new properties and 180 days to purchase one or more of those properties.
2. From the time you decide to do an exchange, you should be looking for your new property. If you haven't started looking yet, you must begin earnestly seeking new properties NOW.
3. For an exchange to be 100% tax deferred, you must acquire new property that is of equal or greater value than the old property; you must also spend all of the net proceeds from the old property in purchasing your new property.
4. IXG will send you a notice containing the original closing date, the expiration date of the 45-day identification period, the expiration date of the 180-day purchase closing date, confirmation of the amount we received from your closing on the old property, and a form by which you notify us of the locations of potential new properties.

5. You must mail or fax to IXG the property

identification form before midnight of the 45th day from the closing of the old property.

## **B. Contract Stage**

1. Negotiate and sign your contract as buyer on the new property.
2. Include language in the contract to establish your intent to do a tax deferred exchange:  
“Buyer intends to do a 1031 Exchange an seller agrees to cooperate with buyer regarding the exchange at no additional cost to seller and no delay to the closing”.  
(The Colorado real Estate Commission requires an additional form.)
3. Identify a title company or closing agent to handle the closing of the transaction.

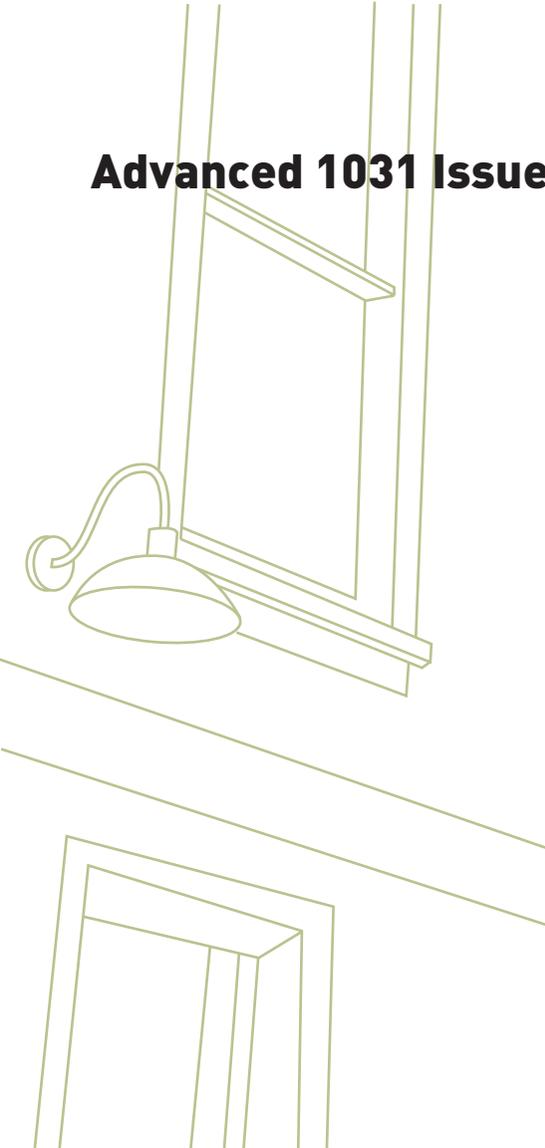
## **C. Closing Stage**

1. Call IXG when you have a signed contract to buy. Information we need includes the phone number, name, and reference number for your closing agent or title

company, a copy of your contract and the purchase price.

2. Let IXG know if you need an earnest money deposit from your exchange account.
3. IXG will wire or deliver to closing the funds necessary to close on your purchase. IXG will contact the title company or closing agent with the necessary documents. If possible, a representative of IXG will be present at closing to obtain signatures on documents.
4. IXG’s TaxAdvantage™ packet provides a final letter and an accounting of the funds held, interest calculations and the 1099 IRS form required for tax purposes.

IXG makes every effort to simplify the 1031 process. We complete all the necessary documents and tax requirements giving you the confidence that your exchange has been completed correctly. We know you will appreciate our service. We specialize in customer satisfaction.

A line art illustration of a window with a lamp hanging from it. The window is partially open, and the lamp is a simple, rounded design with a curved neck. The illustration is composed of thin, dark lines on a white background.

# Advanced 1031 Issues

1. Common Ownership Problems
2. Refinancing 1031 Property
3. Owner Carry Financing in 1031 Exchanges
4. Reverse Exchanges
5. Improvement Exchanges
6. Construction Exchanges
7. Reverse Construction Exchanges

**GO STRAIGHT TO THE SECTION BY  
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# Advanced 1031 Issues

## Common Ownership Problems

Any tax paying entity can do a 1031 Exchange, including C corporations, S corporations, partnerships and limited liability companies (LLCs). Remember, the taxpayer on the old property must be the same taxpayer on the new property.

The most common ownership problem is that owners often don't know how they hold title to the property. If two or three people own a property, they may call each other partners while they legally hold title to the property as tenants in common, but file a partnership tax return to report the income to the IRS. How they file their taxes is critical in the exchange.

Another common ownership problem arises when an investment property is owned by an LLC or partnership. The decision has been made to sell the investment property, and some of the partners wish to do an exchange, while others wish to take the cash. In this situation, a well-intentioned attorney or CPA may advise dissolving the entity so that each owner can choose his own course of action. However, a

1031 Exchange requires that the taxpayer selling the old property be the entity which completes the exchange by purchasing the new property. Keep in mind that the property must also be held in the same name for at least a year and a day. If the entity is dissolved before the exchange, the IRS could argue that the property was held for resale rather than investment, since it was held in the partner's individual name for only a few days from the time of the "buy" through the distribution, to the sale.

Ownership issues can be a real minefield for an exchange. Please call IXG before you enter the exchange process for individualized consultation.

## Refinancing 1031 Property

There is a risk to refinancing the property to be sold because the IRS has ruled that cash proceeds refinanced immediately prior to closing an exchange constitutes taxable boot. The rule of thumb in refinancing before

the exchange is: don't. You can refinance the newly purchased property immediately after the exchange is completed.

## Owner Carry Financing in 1031 Exchanges

If you carry back a note on your sale property, the IRS will treat this note as taxable. As the payments on the note come to you, the principal portion of the payment is subject to the capital gains tax, and the interest portion is subject to ordinary income tax. How can you prevent this note from being taxable? First, the note should be payable to the QI, which puts the note into the exchange. The note must then be converted to cash before you can buy your new property. How do you turn the note into cash? There are three ways. **Number one** is to get the seller of the new property to agree to take the note as part of the purchase of the new property. As a practical matter, you almost never see this. **Number two** is to find someone to buy the note.

Unfortunately, because the note is unseasoned, (i.e., it's a brand new note) any buyer of that note will demand a large discount. **Number three** is that you, as the property seller, buy the note from the QI for face value, and the QI assigns the note back to you. Because you bought the note from the QI at face value, as you receive the principal payments, they're tax free return of basis to you. You will pay income tax on the interest on the note as you receive it, but the principal payments are tax-free. Meanwhile, in your exchange account, the QI is holding cash that can now be used to purchase the new property.

## Reverse Exchanges

What if you want to buy your new property before selling your old property? If you buy the new property in your name, and subsequently sell the old property, the transaction will not qualify as a 1031 Exchange. This situation calls for a reverse exchange. In a typical reverse exchange,

the QI buys and holds (parks) the new property for you until you've closed the sale of your old property. Usually the QI sets up a new entity (call it XYZ) which will purchase the new property for you. You provide XYZ with the funds necessary to purchase the property. You are also responsible for all closing costs on the purchase, but you do not actually take title to the new property – XYZ does. Your loan to XYZ is documented by a promissory note from XYZ to you, a mortgage or deed of trust tying the money to the property, and an exclusive option. The option provides that you are the only person who can buy the new property from XYZ. When your old property sells, the exchange proceeds go to your QI. XYZ then transfers the property to you and you use your exchange proceeds to buy the new property from XYZ. This completes your 1031 Reverse Exchange. From the IRS's perspective, the exchange has not started until the old property sells; it just happens that you buy your new property from XYZ, instead of

from the original seller. When undertaking a reverse exchange, be careful in the selection of your lender. FHA and Fannie Mae-type lenders can be a problem, because they are being asked to lend money to you, but you will not appear on the title for a short period of time. You should seek out a bank or other portfolio lender who will make a bridge loan to you, which can then be converted to long-term financing when XYZ ultimately transfers the property to you.

## Improvement Exchanges

An improvement exchange allows you to buy a fixer-upper with part of the exchange proceeds, and use the rest of the proceeds to make improvements. In an improvement exchange, when you identify the property on the 45-day list, you must also specifically say what improvements you are going to make, and how much they will cost. Like reverse exchanges, the QI will take title to the property while the improvements are being done. The QI cannot transfer the property to you until all of the improvements are completed. You must identify sufficient

improvements to use up all your exchange proceeds and complete the work within the 180-day period.

## Construction Exchanges

In a construction exchange, you buy bare land with exchange money and build a new building on the land. The QI must buy the land for you and begin construction, but unlike an improvement exchange, you can close out your exchange before the building is completed. You must still complete your exchange before the 180 days are up. It's important to note, however, that you cannot take title to the land in your own name at the beginning, or the exchange will be invalid. This is because you would be attempting to use part of the exchange proceeds for just the land, and the remainder for just the improvements, not for a completed, improved property.

## Reverse Construction Exchanges

What if you can't get enough new construction completed within 180 days of your sale to equalize and finalize your exchange? In this case, you can do a reverse construction exchange. Here, the QI takes title to the land with money borrowed from you before you sell your old property. Construction on the new property can begin and be well underway so that the construction is almost complete when the old property closes.

## Reverse Exchange Recent Developments

The IRS issued a ruling (Rev. Proc. 2002-22), effective September 15, 2000, that provides a "safe harbor" in regard to Reverse Exchanges. One of the significant points in the ruling applies time limits to Reverse Exchanges that are similar to those that had previously only been applied to straight exchanges.

Provisions that must be met in order to fall within the safe harbor:

1. From the date of closing on the new property, you have 45 days to determine a list of properties you want to sell.
2. Also from the date of closing on the new property, you have 180 days to complete the entire reverse exchange.
3. Other properties you want to buy or sell as part of the same Reverse Exchange must be identified.

## The Final Answer

There are literally thousands of variations of the scenarios mentioned in this handbook. At Investment Exchange Group, we are glad to consult with you at any time, without charge, and answer your questions about any aspect of 1031 Exchanges. Our CPAs and attorneys, real estate, banking and title professionals offer you the the protection and assurance you need to complete an exchange.

For the Investment Exchange Group office nearest you:

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MEMBER OF



FEDERATION OF  
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