National 1031 Exchange Services, Inc.

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How to Begin:

1. When you list your property with your agent, be sure to disclose your intent to do a 1031 Exchange in the listing agreement

Request buyer's cooperation in the exchange

2. Search for your new Replacement property
    a. Identify the new property within 45 days from the closing on the sale of your Relinquished Property (Day one starts on the day after escrow closes)
    b. Request seller cooperation in the exchange in your purchase agreement
3. Open escrow on the property you are selling and contact us to open your exchange:
    a. Provide us with a copy of the purchase agreement between you and your buyer
    b. Provide us with a copy of the preliminary title report/title commitment
4. Submit 45-day Identification form
    a. Submit your identified replacement property selection on our identification form that will be provided to you
    b. Identification is limited to three (3) properties of any value; or any number of properties over three whose combined fair market value does not exceed 200% of the gross sales price of the property(ies) you sold; or any number of properties of any value providing that 95% of the value of the properties identified are actually acquired.
5. Notify your exchange coordinator as soon as you open escrow on your new replacement property
    a. You must close escrow no later than 180 days following the close of escrow on the relinquished property. Remember: File your tax return (for the year in which you sell the relinquished property) after you close escrow on the replacement property. (You will need t file an extension if your replacement Property escrow closes after April 15th

How it works:

National 1031 Exchange Services acts as a third-party Qualified Intermediary in an exchange. As a principal in the transaction, National acquires the Relinquished Property (the property you currently own) and transfers the property to the buyer. National receives the sales proceeds at the close of escrow and holds those funds for the Exchanger to acquire the new Replacement Property.

National cares about security of your funds. Our documentation clearly defines the role and responsibility of NES as an accommodator in helping the Exchanger to complete their exchange. Funds are invested with the trust department of a major commercial bank for safety and protection. Special accounts requiring co-signors are available if desired.

What is a 1031 Exchange?

An Internal Revenue Code Section 1031 Tax Deferred Exchange represents a legal strategic method for acquiring or selling "Like-Kind" or qualified properties in order to defer capital gains tax. If the Taxpayer meets the prescribed criteria as established by the Internal Revenue Service (IRS), then capital gains taxes may be deferred by "Exchanging" property.

- A Tax-Deferred Exchange represents a method for selling qualifying property or properties and the subsequent acquisition of another qualifying property or properties within a specific time frame. This is the most common type of exchange and is referred to as a Delayed Exchange. This "Exchange" of an investment property for another is tax-deferred and can give the investor greater buying power, and enhance the investor's portfolio. Note: An exchange may not occur with foreign property.

History of a 1031 Exchange:

- IRC Section 1031 has been in existence since 1921. Over the years, however, numerous modifications have been made to the benefit of the Taxpayer. Initially a tax break was provided to property owners who were simultaneously trading properties. The theory was that since the nature of the investment for both owners was not changing as a result of the transaction, no taxes should be collected. This method worked well for property owners who wanted to trade their property simultaneously, but this situation was very rare.
- In 1970, IRC Section 1031 was first questioned. Recognizing that a Simultaneous Exchange was rare, members of the Starker Family brought to court the idea that other methods of property exchange should also qualify for tax-deferred treatment. Historically known as the Starker Decisions, members of the Starker Family vigorously fought to modify IRC Section 1031, making Delayed Exchanges, as well as Simultaneous Exchanges, eligible for tax-deferral. The courts confirmed that an exchange did not need to occur simultaneously to qualify for tax-deferred treatment. This was a monumental decision, but since the courts had made this decision at the state level and not at the federal level, a clear definition to the allowable method of a Delayed Exchange had not been defined nationwide.

Tax Reform Act (TRA) of 1984

- Congress modified Section 1031 to provide consistent rules for Delayed Exchanges and in 1991 the Internal Revenue Service finalized regulations, which further clarified the rules under which Delayed Exchanges could be implemented. From these regulations stemmed the Safe Harbor Rules, which Qualified Intermediaries operate under.

- Generally, if a property is sold after one year and a day, then the long-term capital gains would apply. 15-20% to IRS 13.3% to Franchise Tax Board (CA)
- If a property is sold within one year then the gains would be taxed at the rate of ordinary income. (Individual tax bracket applies)

"Like-Kind" Property

- Replacement Property acquired in an exchange must be "Like-Kind" to the property being relinquished. The term "Like-Kind" refers to the nature or character of the property and not to its grade or quality.

- In an Exchange, “Like-Kind” only applies to real property that has been used for business, trade, or investment purposes. Almost all real estate qualifies for an exchange, with the exception of your primary residence.
- There is some flexibility in this definition. Although the properties involved in an exchange must be “Like-Kind”, they do not need to be exactly alike.

List of properties that can be exchange with one another:

- Single-Family Rentals
- Industrial Buildings
- Golf Courses
- Retail Space
- Farms and Ranches
- Hotels and Motels
- Leases with 30 years + remaining
- Multi-Family Rentals
- Offices
- Land
- Tenant in Common (TIC)

Reinvestment Requirements:

- Real property that is sold must be replaced with real property. The value of what is bought must be equal to or greater than the value of what is sold, less the Real Estate Commission. The proceeds from the sale of the Relinquished Property must be re-invested into the new property rather than sold for cash.
- If any proceeds are left over or used for other purposes, they are considered a gain or referred to as “Boot” and are subject to taxation. If this is the case, the transaction is a partial Tax-Deferred Exchange. You must exchange for “Like-Kind” property and acquire property with loans, equity, and sales price which are equal or greater than the property exchanged.

Example:

Defer 100% of Capital Gains

Relinquished Property → Replacement Property
(equal or greater)

$100,000.00 Sales Price	$100,000.00 Sales Price
$ 25,000.00 Equity	$ 25,000.00 Equity
$ 75,000.00 Loan	$ 75,000.00 Loan (new)

Partial Deferral of Capital Gains Taxes

Relinquished Property → Replacement Property
(less than)

$125,000.00 Sales Price	$75,000.00 Sales Price
$ 50,000.00 Equity	$ 50,000.00 Equity
$ 75,000.00 Loan	$ 50,000.00 Loan (new)

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Specific Time Frames:

- With the close of the relinquished property, you have 45 days to identify in writing the properties you intend to purchase and 180 days (or the due date for your tax return – whichever is earlier) to complete the acquisition of one or more of those properties. In addition, the 45 day identification period and the 180 day exchange period are calendar days. If the 45^{th} day or 180^{th} day falls on a weekend or holiday, the deadlines still apply. There are no extensions for Saturdays, Sundays or legal holidays
- C.O.E.
- Property Identified Acquire Title End of Exchange
- |___________________________|____|
- 45 days 135 days 180 days

Most Importantly

- If you identify one or more properties and it is past your 45^{th} day, you have no right to receive cash before the 180^{th} day.

Identification Rules

Three Property Rule:

- The Taxpayer shall identify only that number of replacement properties which meets one of the rules set forth below:
- The Three-Property Rule – Identify 3 replacement properties without regard to the fair market value of the Properties

$	$	$	You may identify up to three properties, but are only required to purchase one.

200% Rule

Identify any number of properties (more than 3) so long as their aggregate fair market value does not exceed 200% of the fair market value of the Relinquished Property

Relinquished:	Sales Price	200%	Value
	$200,000.00	200% of 200K	=$400,000.00

ID Replacement: 100K + 100K + 100K + 100K =$400,000.00

The 95% Rule

- Identify any number of properties (more than 3) without regard to their aggregate fair market value so long as the Taxpayer received identified replacement properties constituting at least 95% of the aggregate fair market value of all identified replacement properties by the 180th day.

ID Replacement: 125K + 125K + 125K + 125K =$500,000.00

- **You must purchase $475,000 in property**

Suggested Holding Period

- The general rule is that a taxpayer must hold the property for at least two years before it can be considered for Tax-Deferred treatment. This rule applies both to the Relinquished Property and Replacement Properties.
- There is a stricter time requirement when related parties are involved (Under IRC Section 1031, you cannot buy from a related party and be eligible for tax-deferral unless the related party is doing an exchange as well).
- When selling to a related party, the related party must hold the Relinquished Property for at least two years. Selling the property prior to the two year mark will disallow the Exchange.

Internal Revenue Code § 121

- Section 121 (Primary Residence) and the 1031 Exchange:
- If you convert investment property to your primary residence (live in 2 years), you must have owned it for 5 years before qualifying for the benefit of Section 121.
- 1. Exclusion up to $250,000 of the capital gains for a single taxpayer and $500,000 for a married couple filing jointly; and
- 2. The Taxpayer must own and use the home as a principle residence for two of the five years prior to the sale. The ownership and use periods do not need to be concurrent.

You must use a Qualified Intermediary

- As stated by the IRS, a Qualified Intermediary must be used in every exchange, even if the Taxpayer has identified a replacement property prior to selling the old property.
- The Qualified Intermediary acts as the non-biased third party during an exchange transaction. The Intermediary holds all funds and prepares any necessary documentation pertinent to the Exchange. If at any time the IRS feels that the Taxpayer has been in direct contact with the proceeds from the sale of the Relinquished Property, the Exchange will be disallowed. For this reason, it is extremely important that a trusted Qualified Intermediary. (Note: the use of one's own CPA, Legal Counsel, or other agent within the last 2 years will disqualify the exchange.)

Role of a Qualified Intermediary:

- To provide consultation, not tax advice.
- Security of Funds – Funds usually held in Money Market Accounts (second signer if needed)

Delayed Exchange Steps:

- Talk to a Tax Advisor
- List Property for sale
- Open escrow with title company
- Open exchange during escrow with Qualified Intermediary
- Sign Exchange Agreement at the Close of Escrow (C.O.E.) – During C.O.E., the seller will deed property directly to buyer
- ID replacement property within 45 days of C.O.E.
- Close on replacement property(ies) within 180 days of C.O.E.
- So, if you sell or relinquish an investment property and use the proceeds to purchase a "Like-Kind" replacement property, you can avoid paying federal income taxes as specified in IRC Section 1031. Moreover, IRC Section 1031 is a U.S. Tax Code which means an exchange may occur in all 50 United States and the U.S. Virgin Islands. It is possible that a taxpayer may sell property in California and during the same exchange, may purchase replacement properties anywhere in the U.S.

Necessary Steps to complete an Exchange:

- Selling the Relinquished Property – before the close of escrow on the relinquished property, it is necessary for the taxpayer to contact the Qualified Intermediary. The Qualified Intermediary will prepare an Exchange Agreement and contact the closing agent. Upon the close of escrow on the relinquished property, the funds will go directly to the Qualified Intermediary and will be held over the course of the exchange.

Identifying the Replacement Property:

- The Taxpayer will have 45 days from the close of the relinquished property to identify a replacement property in writing. The Qualified Intermediary will provide the identification form needed. The way to identify the property is to fax a written, unambiguous, signed form, and mail the original.

Purchasing the Replacement Property:

- The Exchanger will have 180 days from the close of the relinquished property to purchase the Replacement Property. The Qualified Intermediary will use the money acquired from the sale o the Relinquished Property to purchase the Replacement Property.

Related Parties:

You cannot buy from a related party unless the related party is also doing an exchange

When selling to related party, the related party must hold the property for two years or it will disallow your exchange.

*The definition of related parties is a combination of related parties as defined pursuant to Sections 267(b) and 707(b) of the Internal Revenue Code. Related parties include, but are not limited to, immediate family members, such as **brothers, sisters, spouses, ancestors and lineal descendants. Related parties do not include stepparents, uncles, aunts, in-laws, cousins, nephews, nieces and ex-spouses**.*

Corporations, limited liability companies or partnerships in which more than 50% of the stock, membership interests or partnership interests, or more than 50% of the capital interests or profit interests, is owned by the taxpayer is considered to be a related party.

Convert Investment Property to Primary Residence Restrictions:

You must own each of the relinquished and replacement two years. Then when you go to sell the primary residence that came from a 1031 Exchange, you must be on title for at least 5 years. The longer you live there, the bigger the proration gets. However, the recapture from depreciation recapture doesn't go away.

To illustrate the change let's assume married taxpayers exchanged into a residence; rented it for three years, moved into it and lived in it for two years. The taxpayers then sold it and realized a gain of $500,000

the exclusion would be prorated between the qualified and nonqualified use (the numerator is the period of nonqualified use and the denominator is the number of years the property has been owned):

- Three-fifths (3 out of 5 years) of the gain or $300,000 would not be eligible for the exclusion; and
- Two-fifths (2 out of 5 years) of the gain or $200,000 would be eligible for the exclusion. As a consequence, the taxpayers would pay taxes on $300,000 of the gain (plus depreciation recapture) instead of just the depreciation recapture taxes.