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How to Begin:

Once you list your property with your agent, be certain to disclose your intent to achieve a 1031 Exchange in the listing agreement

Request buyer's cooperation in the exchange (this is a requirement by the IRS).

This is a sample:

Relinquished Property Contract: (Sale or Disposition Property)

Buyer acknowledges that Seller intends to perform a tax-deferred exchange transaction pursuant to Section 1031 of the Internal Revenue Code and Section 1.1031 of the Treasury Regulations and that Seller's rights, title and interest (but not obligations) pursuant to this *[Insert name of Purchase and Sale Agreement or Sales Contract or Escrow Instructions]* will be assigned to Qualified Intermediary, for the purpose of completing Seller's 1031 Exchange transaction.

Buyer agrees to cooperate with Seller and Qualified Intermediary at no additional cost or liability to Buyer, by executing the documents necessary to complete Seller's 1031 Exchange transaction.

Tip: Search for your new Replacement Property during the process of closing on your Relinquished Property

Once you are under contract with your Buyer:

1. Open escrow on the property you are selling and contact us to open your exchange
2. Provide us with a copy of the purchase agreement between you and your buyer
3. Provide us with a copy of the preliminary title report/title commitment

We will prepare the exchange agreement and send to the closing for signature by all parties.

After the closing of your Relinquished Property:

Identify potential new property(ies) within 45 days from the closing from the sale of your Relinquished Property (Day one begins on the day after the escrow closes

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

Submit your identified replacement property selection on our identification form that will be provided to you by our office.

Identification Rules:

Three Property Rule: The Taxpayer may identify up to three properties of any fair market value.

Alternatively, if the undersigned identified more than three properties, the undersigned acknowledges that the aggregate fair market value of those properties cannot exceed 200% of the fair market value of the Relinquished Property. The fair market value of the Replacement Property is listed below.

200% Rule: The Taxpayer may identify an unlimited number of properties provided that total fair market value of all properties identified does not exceed 200% of the fair market value of the relinquished property. (caution: if another buyer pays more than asking price, that could put you over the 200% and could disallow your exchange)

95% Rule: If the Taxpayer identifies properties in excess of both of the above rules, then the Taxpayer must acquire 95% of the value of all properties identified.

Once you are under contract to purchase your Replacement Property:

Request seller cooperation in the exchange in your purchase agreement

This is a sample:

Replacement Property (Purchase or Acquisition Property)

Seller acknowledges that Buyer is completing a tax-deferred exchange transaction pursuant to Section 1031 of the Internal Revenue Code and Section 1.1031 of the Treasury Regulations and that Buyer's rights, title and interest (but no obligations) pursuant to this *[Insert name of Purchase and Sale Agreement or Sales Contract or Escrow Instructions]* will be assigned to Qualified Intermediary, for the purpose of completing Buyer's 1031 Exchange transaction.

Seller agrees to cooperate with Buyer and Qualified Intermediary at no additional cost or liability to Seller, by executing the documents necessary to complete Buyer's 1031 Exchange transaction.

Notify our office as soon as you open escrow on your new replacement property. You must send us a copy of the signed purchase agreement and give us the contact information for the person who is handling the closing.

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 to 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 a major commercial bank for safety and protection. Special accounts requiring co-signors are available if desired.

What is a 1031 Exchange?

The 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 of 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:

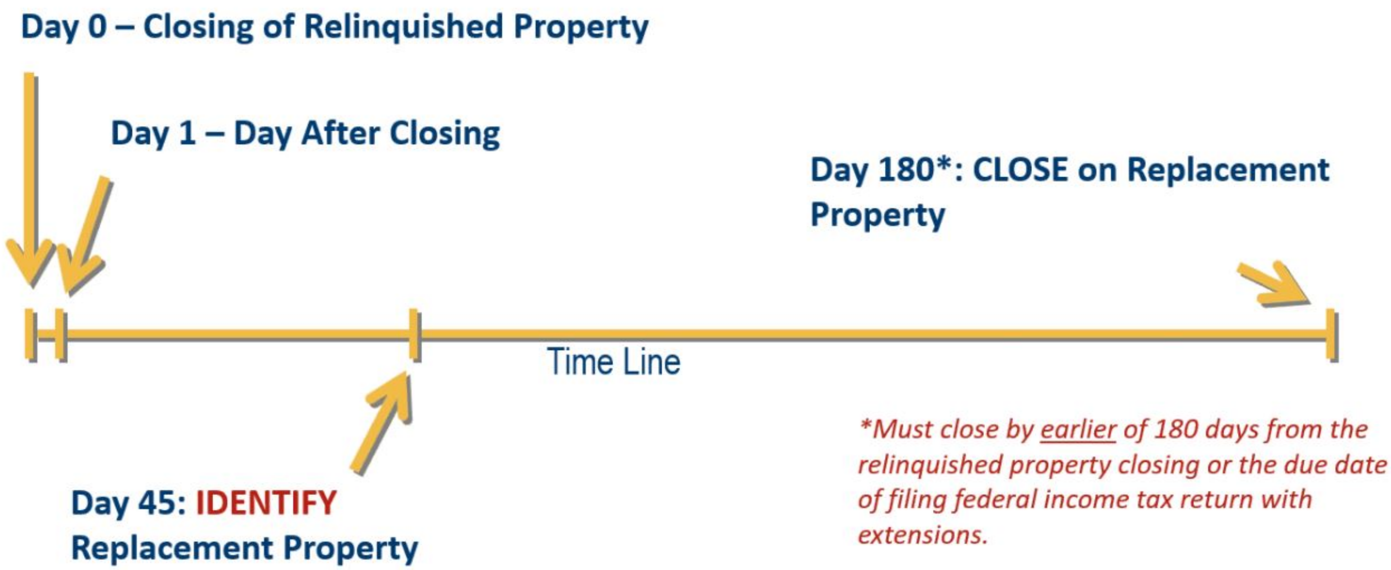
Real property that is sold must be replaced with real property. The value of what is bought must be equal to or greater than the value of what is sold, less the Real Estate Commission and closing fees. The proceeds from the sale of the Relinquished Property must be re-invested into the new property.

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.

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 45th day or 180th day falls on a weekend or holiday, the deadlines still apply. There are no extensions for Saturdays, Sundays or legal holidays.

C.O.E.



Most Importantly,

If you enter into an exchange and decide you **do not** want to identify a Replacement Property or purchase a new property and you want to pay your taxes, we are **not** able to release your funds to you until the 46th day.

If you identify one or more properties, and it is past your 45th day, we are not able to release your funds to you until the 181st day.

Identification Rules

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 (remember – you need to meet the equal or greater rule)

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

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.

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 (if the property you are selling came from an exchange). 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 principal 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:

1. Talk to a Tax Advisor
2. List Property for sale
3. Open escrow with title company
4. 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 of 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 a 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.

Crazy Rules:

Take Cash from your sale: It is considered “**Boot**” and you must pay taxes when you file your tax return.

Mortgage Boot **can be** “**offset**” by **Cash** **Cash Boot** **can not** be offset.

Convert Investment Property to Primary Residence Restrictions:

You must own each of the relinquished and replacement for 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 non-qualified use (the numerator is the period of non-qualified use, and the denominator is the number of years the property has been owned):

Three-fifths (3 out of 5 years rented out) of the gain or $300,000 would **NOT** be eligible for the exclusion; and

Two-fifths (2 out of 5 years lived in it) 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.

If you have a portion of your primary residence held for investment use (rented out a room) then you can use 1031 for that portion of the sale and you would have to purchase new investment property with that portion.

Second Homes:

To have a second home qualify for 1031 exchange you must do the following:

Limited usage:

Not more than 14 days per year

Not more than 10% of the time you rent it out

- (rent 300 days out of they year, you can use it 30 days)
  - (Working weekends don’t count towards usage)

Partnerships:

If you own a property in a Partnership and the partners want to go their own way, You must dissolve the partnership 2 years before you can exchange the property.

Or

One of the partners can **“buy out”** the other partners prior to the sale and the partner that holds 100% of the partnership may do an exchange on his own.

IRS does not like "Drop and Swaps"

Your LLC – Has its own Tax Id Number

Your Name and Social Security Number | **Your Partner's Name and Social Security Number**

You have not held this property for investment under your social security number

Same Taxpayer who transfers relinquished property must acquire replacement property, IRC Section 1031(a)(3)

Favorable Exceptions:

- Disregarded single-member LLC and the sole member
- Grantor and his grantor/revocable living trust
- If Taxpayer dies during the exchange, his estate or trustee may complete the exchange, Rev. Rule 64-161

Same taxpayer must complete the exchange

Relinquished Property		Replacement Property
ABC Partnership	→	ABC Partnership
XYZ Corporation	→	XYZ Corporation
Sam Smith 100% ownership	→	Sam Smith 20% TIC Ownership

Seller Carry Back Note (Installment Sale):

Can be used in a 1031 Exchange.

Note must be **sold** by the end of the exchange period (180 days):

- Get the Seller of the Replacement Property to take the Note as part of the down-payment.
- Sell it to a Third-Party

  (If the Note is sold at a discount, the discounted portion is taxable)

- Exchangor can **keep** the Note and pay taxes on the portions as they are received (**Principle will be taxed as Capital Gains**, **Interest will be taxed as Ordinary Income**)

1031 Tax Filing Requirements

IRS Form 8824 is filed to reflect the exchange on the taxpayer's federal tax return for the year the transaction began (i.e., the year the relinquished property was sold to a buyer). The form requires the taxpayer to provide the following information:

- Description of like-kind property given up
- Description of like-kind property received
- Date like-kind property given up was acquired
- Date property was transferred to other party
- Date like-kind property was identified
- Date like-kind replacement property was received

Required to complete your exchange within 180-days, or the date their tax return is due – whichever is earlier

- If the exchange is closed between October 17 and December 31, must file an extension to file taxes IRS Form 4868 to obtain full 180 days to reinvest exchange funds if needed.

15% Incidental Personal Property

Incidental personal property can be acquired with exchange funds for part of the purchase of replacement property without putting the exchange at risk

To the extent that exchange funds are used to acquire incidental personal property, gain may be triggered since the personal property is not considered Like-Kind

Be careful not to go over 15% because it can **INVALIDATE** the whole exchange.

Rents and Deposits can be considered "Boot"

Disclaimer:

- **While this is general information about IRS section 1031 Exchanges, it does not constitute legal or tax advice. The best way to get guidance on your specific legal issue is to contact an Attorney.**