BREAKWATER 1031

1031 Exchange FAQ

What Is The History Of Tax Deferred Exchanging?

Tax-deferred exchanging has been around a long while. In fact, in some form, it has been with us since the 1920s. However, the difficulty associated with completing an exchange from then up until the late seventies was directly related to those issues which arose around having to complete every transaction simultaneously. That's right, up until the case law which came out of the Starker decisions, every exchange had to be done where all the transfers were completed on the same day. Not an easy task at all.

But what happened with the Starker situation was this: The Starker family sold some timberland to Crown Zellerbach. And, instead of receiving cash in the sale, they took a credit on the books of the company. Then, over the course of about five years, as the Starker family found replacement property they wanted, Crown Zellerbach would buy it and have it deeded to them and applied against their credit on the company books.

Well, you can imagine that the Internal Revenue Service was unimpressed with this entire approach, so they disallowed it and everything ended up in tax court. But interestingly enough, what actually arose from all the proceedings was that the delayed exchange concept was upheld. Granted, not every single one of the Starker transfers was found to be compliant. But enough were, so that for the period between the Starker case law rulings and 1984, delayed exchanges could actually be completed legitimately in the circuit which heard the original case.

Well, obviously, if you no longer had to close everything simultaneously, you'd do a delayed or deferred exchange yourself. So naturally, exchange volume increased. In fact, it increased to such an extent that the Internal Revenue Service went ahead and codified delayed exchanging in 1984 simply in an effort to get some control around the whole process. For instance, that's where our 180-day time frame and identification rules came from.

Since then, we've gotten rules for reverse exchanges which make them easier to complete, as well as several Revenue Procedures and other forms of guidance that deal with many other forms of exchanging. Everything from the programmed exchanging of fleets of cars and trucks to the partial exchange of assets which are influenced by various other sections of the Code.

BREAKWATER 1031

BREAKWATER1031.COM
(310) 940-9430

9940 RESEARCH DR. SUITE 200
IRVINE, CA 92618

What Is A Tax Deferred Exchange?

A tax-deferred exchange represents a simple, strategic method for selling one qualifying property and the subsequent acquisition of another qualifying property within a specific time frame. Although the logistics of selling one property and buying another are virtually identical to any standard sale and purchase scenario, an exchange is different because the entire transaction is memorialized as an exchange and not a sale. And it is this distinction between exchanging and not simply selling and buying, which ultimately allows the taxpayer to qualify for deferred gain treatment. So essentially, sales are taxable and exchanges are not.

What Is Internal Revenue Code Section 1031?

Because exchanging represents an IRS recognized approach to the deferral of capital gain taxes, it is important for us to appreciate the components and intent underlying such a tax deferred or tax free transaction. It is within Section 1031 of the Internal Revenue Code that we find the core essentials necessary for a successful exchange. Additionally, it is within the Like-Kind Exchange Regulations, previously issued by The Department of the Treasury, that we find the specific interpretation of the IRS and the generally accepted standards and rules for completing a qualifying transaction.

What Is The Definition Of Like Kind Property?

Any tax deferred exchange completed pursuant to Section 1031 needs to involve like kind properties. So what is the definition of like kind? Well, first, it is important to remember that like kind refers more to the way a property is used rather than the way it looks. For instance, the typical single family detached home can be both a personal residence or an income property, right?

Okay, so then the definition for like kind essentially boils down to you needing to use your property in one of two ways. And those two methods which make up like kind are property held for investment, and property held for a productive use in a trade or business. Basically property held for income. So as you are out looking for candidate replacement properties, make sure your use of that new property will fit within one of those two categories. And that is the definition of like kind.

What Are The 1031 Exchange Time Constraints?

There are only a few rules which are critical to making your exchange qualify and one of the most significant is the allowance of time in which you have available to complete a delayed or deferred exchange. So here are the two time sensitive rules you need to remember.

Okay, first important time rule. You have a total of 180 days in which to sell your relinquished or exchange property and actually buy and close on your replacement property or properties. That is called the exchange period. Also, if you buy more than one, make sure the last one you close is still within that 180 day window or it won't qualify.

Now often you'll hear a qualifier or caveat regarding the 180 day exchange period which can be very important. And that is this: you actually have 180 days or whenever your tax return is due, which comes first. So what does that mean? If you close your relinquished or exchange property late in the year, say for instance around Thanksgiving, you won't have a full 180 days between then and you're your tax return is due on April 15th correct? Okay, so if that is the case for your transaction, in order to get the full 180 days you will be needing to file an extension in order to include your exchange in your return. That's what that tax return qualifier really means.

Okay, second important time rule. In addition, after you close your relinquished or exchange property, you'll have 45 days from that closing in which to name candidate or targets properties in which to exchange. So that first 45 days out of the total of 180 is called the exchange period.

Also, this is important to remember. You must identify under some basic rules. The only time you don't really have to identify is if all your replacement property is already closed within that 45 day window. That's kind of defacto identification anyway isn't it?

There are two rules for identifying and one exception which we cover elsewhere, but let me give you the rule which is used 95% of the time. It is this. The three property rule. And it is this: You can name or identify any three properties of any value. But your identification must be in writing, and it must be transmitted or postmarked within that 45 day period. Now you can use our online identification tool in the Exchanger Portal if you prefer. It simply handles the transmission aspect electronically and the signatures are digital. But it is pretty convenient if you are on vacation, and today is your 45 day and all you have is a smart phone. But those are the basic rules.

Why Should I Consider A 1031 Exchange?

Any property owner or investor who expects to acquire replacement property subsequent to the sale of his existing property should consider an exchange. To do otherwise would necessitate the payment of capital gain taxes in amounts which can exceed 20%-30%, depending on the appropriate combined federal and state tax rates. In other words, when purchasing replacement property without the benefit of an exchange, your buying power is dramatically reduced and represents only 70%-80% of what it did previously.

What Are The Different Types Of Exchanges?

Although the vast majority of exchanges occurring presently are delayed exchanges, let us briefly explain a few other exchanging alternatives

Simultaneous Exchanges

Investors have been doing simultaneous exchange s since the 1920's. In fact, prior to Congress modifying the Internal Revenue Code as to exchanges and formally approving the concept of delayed exchanging, virtually all exchanges were of the simultaneous type. To qualify as a simultaneous exchange, both the relinquished property and the replacement property must close and record on the same day.

Improvement and Construction Exchanges

In some cases, the replacement property requires new construction or significant improvements to be completed in order to make it viable for the specific purpose that an Exchanger has intended for it. This construction or improvements can be accomplished as part of a structured exchange process, with payments to contractors and other suppliers being made by the facilitator out of funds held in a trust account. Therefore, for instance if the replacement property is of lesser value than the relinquished property at the time of the original transaction, the improvement or construction costs can bring the value of the replacement property up to an exchange level or value which would be equal to the relinquished thereby allowing the transaction to remain tax free. Improvement and construction exchanges can be tricky however. That's because the process does require the use of a concept which we use in reverse exchanges. Namely, a warehousing of the title until such a time as the improvements are done or the 180 days is close. This is because technically you cannot exchange into property you already own. So if you bought the replacement and then did the improvements, the value you added would not count towards the exchange. That is why we use what is called an EAT or exchange accommodation titleholder.

Reverse Exchanges

IThe reverse exchange is actually a misnomer. It represents an exchange in which the Exchanger locates a replacement property and wants to acquire it before the actual closing of the relinquished or exchange property. Since the Exchanger cannot purchase the replacement and later exchange into property that he already owns, he must find a method to acquire the replacement property and still maintain the integrity of his exchange. Reverses are typically accomplished in two formats based upon transaction logistics and the financing needs of the Exchanger. The Exchange Last strategy is utilized only when the Exchanger requires traditional financing to complete his acquisition of the replacement property.

Since few lenders would lend dollars to the Exchanger with the facilitator or Qualified Intermediary (known in this case as an Exchange Accommodation Titleholder) on title, it is necessary for the facilitator to warehouse or hold the title to the relinquished property. In this approach, the exchange is complete at the moment the Exchanger accepts the title to the new replacement property.

However, with the prospect of the exchange being complete, it is necessary to balance equities between relinquished and replacement, prior to closing. In other words, upon closing the replacement, there must be an equal amount of equity in the replacement property as is expected to come out of the later sale of the relinquished property. Then, at the time of the later sale of the relinquished or exchange property, any debt is retired and the Exchanger is repaid any dollars which he advanced for the replacement property acquisition.

In an Exchange First scenario, the facilitator, with the aid of a loan from the Exchanger, acquires the replacement property and warehouses or holds the property title until such time as the relinquished property is sold and the exchange can be completed. At this point we need to insert several caveats regarding reverse exchanges. They tend to be more complicated than other exchanges and because they involve the holding of title by a facilitator in the form of an Exchange Accommodation Titleholder, they require extensive planning. Do not undertake a reverse exchange without the assistance of an experienced and knowledgeable facilitator or intermediary.

Delayed or Deferred Exchanges

Generally, when one discusses exchanges, the type of exchange referred to is the delayed or Starker exchange. This term comes from the name of the Exchanger who was first challenged for a delayed exchange by the IRS. From this tax court conflict came the code change in 1984 that formally recognized the delayed exchange for the first time. As mentioned earlier, this is now the most common type of exchange. In a delayed exchange, the relinquished property is sold at Time 1, and after a delay, the replacement property is acquired at Time 2. The timing requirements are these: you have a total of 180 days or the due date of your tax return to complete an exchange. That is the exchange period. And, the first 45 days of the 180 is known as the identification period in which you need to identify some candidate or target properties to serve as your replacement. And that's the types of exchanges.

Define Equity And Capital Gain?

Equity and Gain are both important to an exchange, but they are never the same number. Let's take a cursory look at how you determine both equity and gain? First equity represents the hard earned value that is yours in any property you own. So, if you take your gross selling price and subtract your closing expenses or closing costs, and then further subtract the amount of any debt, that remaining number which is left over will be your equity.

Now how about capital gain? Well in order to determine gain we need to know what is called your costs basis. And your cost basis is going to be informed by when you bought the property. So when you bought the property you had a purchase price correct? Well that will be the start of your cost basis, which actually changes over time.

For instance, if you've done any improvements to the property that amount should be added. And likewise, if you've deducted any depreciation while you've owned the property that will be subtracted. Therefore, lets determine your cost basis and gain this way: Let's find our final cost basis or adjusted basis. That will be our original purchase price, plus any improvement, and then less any depreciation, that gives us our final adjusted basis. Now let's once again take that net selling price from our sale, deduct our final adjusted basis, and bingo, that's our capital gain.

One last thing. Here is a very simple rule that works in exchanges if you want to have a totally tax free transaction. Number 1, buy a replacement property that is equal or greater in value than your net selling price, and 2, move all your equity from the old property into the new one. If you do those two things, plus replace your debt, you'll be in excellent shape.

GENERAL DISCLOSURE

Not an offer to buy, nor a solicitation to sell securities. Information herein is provided for information purposes only, and should not be relied upon to make an investment decision.

All investing involves risk of loss of some or all principal invested. Past performance is not indicative of future results. Speak to your finance and/or tax professional prior to investing.

Securities offered through Emerson Equity LLC Member: FINRA/SIPC. Only available in states where Emerson Equity LLC is registered. Emerson Equity LLC is not affiliated with any other entities identified in this communication.

1031 RISK DISCLOSURE

- There is no guarantee that any strategy will be successful or achieve investment objectives;
- Potential for property value loss – All real estate investments have the potential to lose value during the life of the investments;
- Change of tax status – The income stream and depreciation schedule for any investment property may affect the property owner's income bracket and/or tax status. An unfavorable tax ruling may cancel deferral of capital gains and result in immediate tax liabilities;
- Potential for foreclosure – All financed real estate investments have potential for foreclosure;
- Illiquidity – Because 1031 exchanges are commonly offered through private placement offerings and are illiquid securities. There is no secondary market for these investments.
- Reduction or Elimination of Monthly Cash Flow Distributions – Like any investment in real estate, if a property unexpectedly loses tenants or sustains substantial damage, there is potential for suspension of cash flow distributions; Impact of fees/expenses
- Costs associated with the transaction may impact investors' returns and may outweigh the tax benefits

BREAKWATER1031.COM
(310) 940-9430
9940 RESEARCH DR. SUITE 200
IRVINE, CA 92618