

Using The 1031 Exchange to Zero Out Taxes on The Sale of Your Property

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WHAT IS A 1031 EXCHANGE?

Briefly stated, a 1031 exchange is a legal IRS provision that allows a property owner to avoid taxes on the sale of their investment/business real estate by acquiring another like-kind investment/business property within certain IRS requirements & time limits.

EXCHANGES ARE GENERALLY NOT SWAPS OR 2-WAY BARTER!

One of the biggest misconceptions about exchanges is that they are “pure” exchanges or 2-way barter. This is generally not so. Here is what typically happens:

- ⇒ At the first settlement you sell (“exchange”) your relinquished property to “Joe Buyer”
- ⇒ At the second settlement you will acquire the replacement property from another person, let’s say, “Mary Seller”
- ⇒ Joe Buyer and Mary Seller will have nothing to do with the exchange
- ⇒ The above settlements must be performed within 180 days of each other
- ⇒ Under specified IRS regulations
- ⇒ Including using a Qualified Intermediary

When you hear the word “EXCHANGE”, think of at least 2 Closings. NOTE: 2-Party direct exchanges happen occasionally. They generally occur among a closed circle –permissible relatives, friends or acquaintances.

RECOMMENDATION: Outside of the above closed circle, you should generally try to avoid a 2-party exchange, because such a “marriage” is difficult to structure. The proven result has usually been wasted time, effort and expense. Again, typically you will need to find “Joe Buyer” for your relinquished property and find a replacement property from “Mary Seller”. (Joe Buyer & Mary Seller have nothing to do with the exchange.) TAX TIP: If you do a 2-party exchange, you should still follow the IRS safe harbors including using a Qualified Intermediary.

THE POWER OF TAX-FREE ROLLOVERS

At its essence, a 1031 exchange is simply a tax-free rollover is a legal strategy to avoid taxes on the sale, transfer or disposition of assets by reinvesting in other qualifying assets within certain time periods and under specified IRS rules. Rollovers allow earnings & profits to compound Tax-Free. The purpose of rollovers is to improve the equity position of an investment portfolio and thus enhance the wealth of the individual.

THE INVESTOR CAN USE THE TAX-FREE PROFITS FROM THE SALE OF THEIR APPRECIATED REAL ESTATE TO BUY AN EVEN BETTER INVESTMENT PROPERTY--

Because they are not taxed on the profit, investors have full use of their equity for a larger down payment, which combined with leverage, can dramatically increase their purchasing power for a better investment. In addition to superior amenities, the new investment can have greater potential for more rapid appreciation enhancing the wealth of the owner.

EXAMPLE: The Smith's will be selling their rental property that they have owned for many years. If they sell outright, the Smith's will incur \$30,000 of taxes on the large gain. However, because of the ability to do a 1031 exchange they will zero out taxes. The \$30,000 in tax savings can be used for a down payment on a larger investment property. As a 30% down payment, the \$30,000 in tax savings (alone) give the Smith's an additional \$150,000 worth of buying power if they obtain a new investment with an 80% loan to value ratio.

\$150,000 DIFFERENCE! The \$30,000 in taxes saved, combined with leverage, magnifies to a whopping \$150,000 difference in additional buying power. If the rental property appreciates at a modest 3% per annum in the next six years, the additional buying power of \$150,000 would compound to over \$179,000. Because of the tax-free rollover (or exclusions), the Smith's have increased their wealth by \$179,000.

TAXES ON GAINS ARE A WEALTH DESTROYER WITHOUT

1031 Without the Tax-Free benefits of Section 1031, the investment property owner would have to pay taxes on the realized gain which is the difference between the adjusted tax basis and net selling price of the property. In rental properties, there are several factors that can substantially (and quickly) increase taxable gain:

1. Appreciation (even modest appreciation over time).
2. Depreciation write-offs - reduce the tax basis of the property which has the same effect as appreciation - increase gain.
3. Any prior deferred gain on another rollover will also increase gain.
4. A section 108(c) exclusion from debt cancellation reduces basis and increases gain.

[ALERT: Items 2 to 4 will create what is known as “phantom income” which is taxable income but without receiving the corresponding cash.

Consequently, even without equity appreciation it is still possible to have a sizable phantom gain because of these non-cash taxable adjustments such as accumulated depreciation, a prior deferred gain, a 108(c) election, etc.]

Such gain on the sale of investment property generally results in multiple tax liabilities that can equate to a “total” tax bracket of 30%, 35% or even higher.

THE BENEFITS OF 1031 ROLLOVERS ARE NOT JUST THE TAX DOLLARS THAT YOU SAVE, BUT ALSO THE ADDITIONAL WEALTH THAT CAN BE ATTAINED WITH THESE SAVED TAX DOLLARS!

“TAX DEFERRED” OR “TAX FREE”? -- THE POWER OF DEFERRAL VIA THE TIME VALUE OF MONEY = TAX-FREE!

A. You sell an investment property via a 1031 tax - free exchange and consequently save \$20,000 in taxes. You can acquire another \$100,000 worth of real estate with the \$20,000 tax savings as a 20% down payment (with 80% leverage). If you are a savvy bargain hunter such as I am, that \$100,000 of additional RE is really worth \$140,000. Now look

what you have accomplished -- Not only did you save the \$20,000 in taxes, but also used the \$20,000 to accumulate another \$40,000, plus future growth. The \$40,000 is 2 times more than the \$20,000 original tax savings. And for those technicians out there is say a 1031 exchange is tax "deferred" and not "free", you are technically correct, but entrepreneurially wrong! Technically, when a property is rolled over via 1031 the untaxed gain does not go away but stays with each rollover and would become taxable if the property were eventually sold outright. This is why the untaxed gain is called a "deferred gain". However, with the power of the time value of money, the tax savings can be reinvested to accumulate to an amount that is even greater than the original taxes saved, as demonstrated by this example.

B. INTEREST-FREE LOAN: Looking at it another way, the tax-deferred savings are a government loan with these great terms - NO interest, NO payments, you pay it back when you want (i.e. when you decide to dispose of the property in a taxable sale), and you may never have to pay back the loan (taxes), as per the next two paragraphs.

C. DEATH PERMANENTLY ELIMINATES GAIN: There is an old adage - "Defer, Defer, Defer - Die!" That is, by continuing to rollover property until death, the gain is no longer deferred but permanently eliminated. This is because under the tax law the death of the property owner will effectively cause an elimination of the taxable gain by a "step-up" of the tax basis to the fair market value of the property. As a result of employing section 1031, your heirs will have a much larger estate not only from the taxes saved but also from the years of compounded earnings on these taxes saved.

D. HOMEOWNER EXCLUSIONS CAN ALSO PERMANENTLY ELIMINATE DEFERRED GAIN: Suppose the exchange property is a rental house, which after a requisite time for rental, is converted to a principal residence for 2 years. The property owner can then use the \$250,000/\$500,000 exclusions to permanently eliminate the deferred gain.

ANOTHER 1031 MISCONCEPTION - "LIKE KIND" IS NARROW

NO WAY! It is true that one of the requirements for a qualifying 1031 rollover is that the properties must be “like-kind”. However, the term "like-kind" is not nearly as narrow as it sounds. 1031 rollovers apply to a diversity of small, large, residential, commercial, industrial, rural, resort-area or any combination of such investment properties. For example, raw land can be rolled over into income producing rental property or vice versa.

(The like-kind requirement is further discussed in Chapter 33). Moreover, several properties can be disposed of or acquired via a 1031 rollover. There is a gourmet variety of diversified options and investment goals that will be illustrated throughout this entire book.

THEN WHY ARE 1031'S LITTLE KNOWN & UNDERUTILIZED?

- . Lack of knowledge
- . Lack of training and education in the field
- . Fear of the unknown
- . Unfounded fear of the IRS
- . Misconceptions or “old wives’ tales” about Exchanges
- . Unconcerned or inept Accountants, Attorneys, Realtors, etc.

NONE of the above are good reasons and therefore should not stop you from enhancing your wealth. 1031 Tax-Free Exchanges are vehicles of wealth accumulation which are legal, if you simply follow the IRS safe harbor regulations.

WHEN NOT TO USE SECTION 1031

As with any other planning tool, 1031 rollovers should be appropriately employed in accordance with the entrepreneur's objectives. Consider the following scenarios:

1. IF THE PROPERTY WILL BE SOLD AT A LOSS. A realized loss will incur on the sale of investment or business-use RE when the adjusted tax basis exceeds the net selling price. Under Section 1031 losses are deferred as well as gains [IRC1031(a)(1)]. Therefore, to recognize and deduct the loss, you should have a clear-cut sale and not a 1031 exchange.

2. WHERE ONLY A NOMINAL AMOUNT OF TAXES ARE DUE. What is a nominal amount of taxes? This is subjective to the individual situation. I've seen individuals employ 1031 even only with \$2000 or \$3000 dollars in "net tax savings" ("net tax savings" being the total taxes saved less the additional costs to do the exchange). It is true \$2000 or \$3000 of immediate net tax saving won't make you rich but can pay for a vacation, high school or community college tuition, be enough for an IRA or Keogh contribution. Of course, any reduction in depreciation deductions (because of a possibly lower basis on the replacement property) should also be considered here.

BUT DON'T FORGET THE TIME VALUE OF MONEY! Immediate tax savings via 1031 as opposed to deferred tax savings via higher depreciation deductions without 1031, are still more beneficial to you. Moreover, by exchanging up in value, you can have an increased depreciation basis in the replacement property. Moreover, "basis" doesn't make you money like MONEY itself.

3. WHERE THERE ARE LOSS CARRYOVERS SUCH AS PASSIVE LOSS OR NET OPERATING LOSS (NOL) CARRYOVERS. There may be enough of such carryovers to offset any gains to a point where a 1031 exchange is not worthwhile.

> WATCH THIS: You can combine loss carryovers and 1031 rollovers. For Example, suppose on the sale of investment real estate, you have a total realized gain of \$150,000 and a \$50,000 loss carryover. After applying the \$50,000 loss carryover, there is still a significant gain of \$100,000 which can be avoided by a 1031 rollover.

TAX POINTER: Even with loss carryovers, it still may benefit you to do a 1031 exchange.

WHERE THE INVESTOR IS LIQUIDATING AND WANTS OUT OF REAL ESTATE

Here liquidating-minded property owners should be asked these 2 questions:

- (1) "Upon liquidating, what will you do with the tax-drained cash?"

The probable answer to this first question is that they will somehow spend it, squander it, or put it in a 1.25% bank CD. Furthermore the 1.25% CD on an after-tax-drain basis is really a negative yield when inflation is taken into account! By prudently employing the wealth accumulation benefits of section 1031, the investor can create a forced savings into real estate which can generate a superior yield, especially on an after-tax basis.

- (2) "What do you really want to avoid - Real Estate or Tenant Management?"

If the investor wants to avoid management then they should consider liquidating out of management and NOT out of the hand that fed them - Real Estate. By staying in real estate, they can take advantage of the wealth accumulation benefits of 1031.

BEWARE OF TAXABLE GAIN ON PERSONAL PROPERTY UNDER REVISED 1031 EXCHANGE RULES

Prior to the enactment of the Tax Cuts and Jobs Act of 2017 many types of property, including personal property, collectible articles and the like could be exchanged pursuant to Section 1031 even though most people considered the section to be for real property. Under the prior law since personal property was also eligible for rollover treatment a 1031 exchange would result in no gain on the portion of the investment allocated as personal property under the componentization. However, 1031 exchanges are now exclusively permitted on real property. Therefore, that portion of a real estate rental which is allocated as personal property is not eligible for exchange treatment. The difficulty will be in obtaining a fair market value for the personal property. Knowledgeable purchasers may be willing to agree to a fair market value for the personal property and execute a separate bill of sale for the personal property. However, many purchasers will not be willing to agree to a value due to a lack of understanding or because the purchaser will be using the property as a primary residence and want to be able to deduct the full amount of interest paid on the mortgage (personal property would be excluded from a schedule A deduction). Our recommendation is to obtain an appraisal of the personal property if that is feasible. Until the IRS issues guidance on valuing personal property (such as establishing a safe harbor) or until the Tax Court rules on the issue it is the author's advice to develop a reasonable method for calculating the value of the personal property through reference to builders cost guides.

Requirement: QUALIFIED INTERMEDIARY (“QI”) - The IRS requires that ALL exchanges (delayed and simultaneous) use an independent, unrelated “qualified intermediary”, IRS Regulations 1031(k)-1(g)(4) and. 1031(b)-(2).

(1) **What is a QI.** The QI is a “middleman” that will acquire and transfer the relinquished and replacement properties to *create the “exchange”*. These

acquisitions and transfers are generally accomplished by exchange documents and not by additional deeds. In other words, there is no need for additional deed transfers (in most exchanges). Just the usual types of deeds can be prepared as you would with any other settlement. In fact, the QI does not even have to be at settlement.

- (2) **A QI is required on All 1031's.** The QI is a “safe harbor” in the IRS regulations. This safe harbor function is typically done by a private service company that is retained by the real property owner doing the exchange. The QI prepares the necessary documentation and forms to create the “exchange” so that it qualifies under IRS regulations. At the present time there is no licensing requirements for QI's and most title agencies are not QI's.
- (3) **Fees.** The fees of QI's vary. Generally, in comparison to the wealth accumulation benefits of 1031's they are extremely reasonable. For example, for a residential exchange a typical fee may be a \$2000 to \$4000. Let's say a fee of \$4000 to save taxes of \$40,000 equates to a **1000% return!** The fees for commercial exchanges would be higher but the results even are more staggering.
- (4) **A “limited service” QI** will only prepare the documentation and act as escrow for the 1031 exchange. They will not help you to structure your exchange. They do not advise you on the tax law or accounting aspects of your exchange.
- (5) **A “full service” QI** does exchanges *full time* and will not only prepare the essential documents, but also will counsel and guide you on all of the technical aspects of your 1031 rollover. This is an important part of the service because most tax professionals are not *1031 Exchange Specialists*.

RECOMENDATION: You should engage a *full-service QI* who will be readily available to render you technical advice throughout your 1031. Moreover, you should engage the QI well in *advance* of any closings.

Requirement: “QUALIFIED ESCROW ACCOUNT” –

(1) The qualified escrow account is also a “safe harbor” in the IRS regulations. IRS Regulations 1031(k)-1(g)(3). When you settle on your real property you must not receive the sales proceeds - such funds must be held in a “qualified escrow account” (with a qualified escrow agent) for the purpose of acquiring replacement real property. The 1031 escrow is required in a delayed* exchange.

***NOTE:** Simultaneous exchange closings (of the relinquished and replacement properties) will generally not require escrow but do require a *qualified intermediary*. Reg. 1.1031(b)-2.

(2) Can be a separate company from the QI. The escrow agent can be a company separate from the intermediary (QI) such as a local title company or bank, or it can be the QI.

NOTE: “Escrow” and “Intermediary” are two separate safe harbors. “Escrow” holds the net sales proceeds from the closing of the relinquished real property. “Intermediary” acts as middleman creating the “exchange” with the proper documentation. Both functions can be done by two separate companies or by one company.

(3) NO actual or constructive receipt. Once the funds are in the escrow account, you must not have the actual or constructive right to receive such funds. {IRS regulation 1.1031(k)-1(g)(6)}. The account must be in the name and ID number of the escrow agent. The escrow account can only pay for expenditures related to the acquisition of replacement real property such as earnest money deposits, commissions, closing costs and the funds needed at settlement for the replacement real property. It cannot make distributions directly to the exchanger or it cannot pay for personal expenses of the exchanger.

(4) NOT security for a loan. The escrow account cannot be used as security or collateral for a loan. However, it *can be* used as an asset on a financial statement or mortgage application.

(5) **OK to keep escrow interest provided it is also restricted.** You can keep any interest on the escrowed funds provided it is restricted in the same manner as the corpus.

ALERT: The company that holds the funds should be bonded, insured, funded and have a well-established, pristine reputation. They should also be a duly authorized corporation or LLC where there is *continuity of life* and the incapacity of an officer, shareholder or member will not erase the company's existence, which in turn could cause the disqualification of the 1031 and the loss of your escrowed funds. Carefully check them out and ask for references.

Requirement **BOTH THE QI AND ESCROW AGENT MUST BE "QUALIFIED"** - *Qualified* means that the intermediary and the escrow agent cannot be "agents" of you, the exchangor. Such agents (or "disqualified persons") would be you, your employee, attorney, accountant, mortgage banker, real estate agent or broker. Included here are certain related parties - lineal descendants [under IRC 267(b)] such as parents, grandparents, children, brothers, sisters as well as more than 10% entities that you own (such as a corporation, LLC or partnership, IRC 707(b)). All of these are known as "disqualified persons" and if you use them for your QI or escrow agent, your exchange will be disqualified. {IRS regulation 1.1031(k)-1(g)(4) & (k)-1(k)}. The QI and escrow agents must be *independent & unrelated* parties.

NOTE: While the QI is not allowed to act as your accountant, attorney, etc., they are permitted to render *1031* tax advice related to your exchange. This is why it is important to use a full-service QI who does render such advice.

A title company *can* be the escrow agent holding the funds from the settlement of the relinquished real property

ALERT: Provided that you, your employee, your attorney, accountant, mortgage banker, Realtor or any lineal descendants do not own more than 10% of the company, then the title company can be the escrow agent (provided these same rules are met).

CAUTION! TRUE STORY: Years ago, when I did have my own QI company, the client's attorney suggested that we use the title company doing the closings to escrow the funds from the closing of the relinquished property. But, through our *1031 Pre-planning Diagnostic Questionnaire*, I knew that the attorney also owned the title company. Because the attorney was "agent" to the exchangor and owned more than 10% of the title company, the title company could not be the escrow agent (or the QI), even though this was the first time the attorney represented the client. The attorney was representing them as legal advisor, not as a 1031 consultant. As a solution we used another unrelated title company as escrow agent. We then had a *qualifying 1031*.

1031 TIP: Again, make certain that you use a *full-service* intermediary company that thoroughly knows 1031 rollovers and does a *pre-planning* review to ensure compliance to the IRS regulations. Engage the QI well in *advance* of any closings, even before you have a buyer. Do it right!

Requirement: THE CORRECT DOCUMENTATION MUST BE USED

Such documentation should contain the "magic language" that conforms to *current* IRS regulations. The QI will prepare the documents, the most important being the following: *1031 Exchange Agreement, 1031 Exchange Escrow Agreement, 1031 Exchange Addendums and Assignments - Relinquished and Replacement Properties, 45-Day Identification Letter, 1031 Exchange Settlement sheets - Relinquished and Replacement Properties.*

OTHER ESSENTIAL DOCUMENTS (not usually prepared by the QI):

IRS REPORTING FORM 1099S: On form 1099S is a box for the insertion of what is called the “*gross proceeds*”. In a 1031 exchange transaction the amount inserted here should be zero (“0”). The box at the bottom should also be checked that the *transferor* (the exchangor) will “*receive property or services as part of the consideration*” (as this is a 1031 exchange). The exchangor’s name and federal ID number are also to be inserted. If the QI is a corporation or LLC (which they should be), then the QI does not receive a 1099. The 1099S is generally prepared by the title company or closing attorney for the relinquished real property.

IRS INCOME TAX REPORTING FORMS* - Forms 8824, 4797, Schedule D. These are generally prepared by the exchangor’s tax advisor.

***ALERT:** These are the only forms that are sent to the IRS. Thus, their proper preparation requires consummate tax expertise with careful attention to details for audit-proofing. Most CPA’s do not know how to prepare them properly. Moreover, IRS instructions are very confusing and misleading.

Requirement: TWO TIME REQUIREMENTS, 45 & 180 DAYS -

Starting from the first closing of your relinquished real property, you must adhere to two sets of time requirements that run concurrently:

- (1) 45 days to identify replacement real property (see below)
- (2) 180 days to close on identified replacement real property.

Both run *parallel* from the *closing date* of the relinquished real property; both must be met for a qualifying exchange. IRC 1031(a)(3); Reg. 1-1031(k)-1(b)(2).

(The 45 days comes out of the 180 days). There are NO statutory extensions to these deadlines (except for reverse exchanges).

1031 TIP: If the settlement date of your relinquished real property is between October 15 and December 31, you may have to file for an extension of your tax return to have the full 180 days. File any extensions correctly and timely.

ALERT 1: It is the *shorter* of 180 days or the due date (including extensions) of the taxpayer's tax return. [Regulation 1.1031(k)-1(b)(2)(ii)]. For example, an individual taxpayer closes on their relinquished real property December 18. From this date, 180 days is June 16 of the following year. However, the taxpayer only has until April 15 of that same following year to acquire identified replacement real property, unless they file a 4-month extension by April 15 (with the 1040). In one case, the taxpayer filed their tax return by the April 15th due date (no extension) but acquired replacement real property after that due date. Even though the real property was acquired before the 180-day time limit, the exchange did not qualify because an extension was not filed. (*O.E. Christensen, TC memo 1996-254*). **COSTING THEM THOUSANDS BECAUSE OF SIMPLE THING AS NOT FILING AN EXTENSION!**

File the extension! For your 1040, and if applicable file an extension for the entity that did the exchange such as a partnership or LLC. Extensions have other benefits as well; see Ch. 2 for how to file extensions.

ALERT 2: The number of days in each period is not extended if the last day of the period falls on a Saturday, Sunday or legal holiday. You must report the 45-day and 180-day dates when you file your tax return on IRS form 8824.

THE 45-DAY IDENTIFICATION OF REPLACEMENT PROPERTIES

- a) The ID Is done by the exchangor sending a letter to the Q.I. listing the specific addresses of the identified replacement properties and by *signing* the letter.
- b) The letter can be mailed, faxed, emailed or delivered to the Q.I. and is to be postmarked no later than midnight of the 45th day following the closing of the relinquished real property. You should obtain *proof* of sending (e.g. - Fed Ex receipt).
- c) Limitation as to the number of replacement properties - You can identify up to 3 properties regardless of their value with no problem. Depending on the sales price of the relinquished real property it is possible to go *above* 3 properties under a special rule known as the “200% rule” (see the next page).
- d) You do not have to be obligated to acquire all 3 replacement properties, but you must acquire at least one of them within the 180-day exchange period. For example, in a letter to the Q.I., Ms. Investor timely identifies properties A, B, and C and ends up acquiring property F..... the “*Stands for Flunk!* She does *not* qualify for the 1031 because she did not acquire A, B, or C.
- e) TWO EXCEPTIONS TO (d) ABOVE:
 - 1. Any replacement real property closed on within the 45 days is deemed to be *automatically identified*. In the above example, if “F” were closed on within the 45 days then it would have qualified for the 1031 rollover.
 - 2. Revocation - You can revoke prior identifications. It must be done in writing to the Q.I. and within the same 45 days. In the above example, if A or B or C were timely revoked and replaced with F then it would have qualified for the 1031.

IDENTIFYING MORE THAN 3 PROPERTIES (200% VALUE RULE):

Within the 45 days, you can identify more than 3 properties, but their combined fair market value must not exceed double (200%) of the selling price (fair market value) of your relinquished real property (the property you are selling via the exchange).

EXAMPLE: If the selling price of your relinquished real property is \$100,000, then 200% or double this amount is \$200,000. If you identify 3 properties (A, B & C) whose combined value is \$400,000, you are OK because you only identified 3 properties. (Under the 3-property rule where values are not relevant). However, had you identified 4 properties (A, B, C & F) whose combined value is \$400,000, then you would not qualify for the exchange, because you flunk the 3-property rule (you are over 3 properties) and you flunk the 200% rule (at \$400,000 you are over \$200,000 which is 200% of the selling price of your relinquished real property).

ALERT: Although the regulations are not a 100% clear on this, it would appear safe (and prudent) to assume that each separately deeded property is a single parcel for purposes of these rules. For example, Condo A and Condo B are right next door to each other and they are separately deeded. They still are two separate properties. The same would appear to hold true for two separately deeded adjoining parcels of land*.

[*PLANNING: If the same owner owns both parcels, you may be able to have your real estate attorney do an *assemblage* and merge the two deeds into one. Now you have two parcels, but *one* property for the purposes of the 45 ID].

RECOMMENDATION: Because values can be arbitrary, you generally should try to stay within the 3-property rule.

Requirement: “**LIKE-KIND**” - Both the relinquished and replacement properties must be "like-kind". This is generally a very broad category with many diverse options. Just about any type of rental, or investment *real*

estate would qualify. IRC 1031(a)(1), Regulation 1.1031(a)-1(b) and Regulation 1.1031(a)-1(c).

A. EXAMPLES OF LIKE-KIND REAL ESTATE CATEGORIES:

- In the *Residential* Sector - Rental houses, rental condos, rental coops, duplexes, triplexes, quadraplexes, apartment buildings.
- In the *Commercial* Sector - Shopping centers, retail stores, office buildings, motels, hotels, B&B's, parking lots, ranches, farms, trailer parks, storage facilities, garages.
- In the *Industrial* Sector - Warehouses, plants, factories, storage facilities, etc.

Plus, any other type of Rental, *Business-Use* or *Investment* real estate, considered to be *real* property under local law:

- A. Rental property would be residential, commercial or industrial property that you rent out to others.
- B. Business-use property is property you would own and use in your own business, such as an office building for your own consulting company or a plant for your manufacturing operation.
- C. Investment real estate is property you hold for passive appreciation such as raw land (YES, land also qualifies, IRS Reg. 1.1031(a)-1(b)(c); Rev Ruling 72-515}.

You can go round-round, get around! Via a 1031 exchange you can "rollover" the above types of like-kind real estate any which way you want:

- ⇒ From *residential* to *commercial* or vice versa
- ⇒ From *residential* to *industrial* or vice versa
- ⇒ From *commercial* to *industrial* or vice versa
- ⇒ You can rollover a *rental house* into an *office building* or vice versa.

- ⇒ You can rollover a *rental condo* into a *shopping center* or vice versa.
- ⇒ You can rollover a *shopping center* into an *apartment building* or vice versa.
- ⇒ You can rollover *farmland* into a *rental house* or vice versa.
- ⇒ You can rollover *commercial business-use* real property into *land* or vice versa
- ⇒ You can rollover *land* into *income producing rental* real property or vice versa
- ⇒ You can rollover an *apartment building* into *ground leases* or vice versa
- ⇒ You can rollover a *part tenant-in-common interest* into a *full fee simple ownership* or vs.
- ⇒ You can rollover *commercial business-use* real property into *residential rental* real property or vs.
- ⇒ You can rollover *several* properties into *one* property or vs. You are not limited to just one property. Several properties can be exchanged in a 1031 transaction.
- ⇒ You can rollover to and from any one of these types of properties in *any location within the U.S.*

B. RELATED PARTY RULES PERTAINING TO LIKE-KIND:

Exchanges between **certain related parties** under IRC 267(b), where the replacement real property is subsequently disposed of *before* the end of 2 years, the property is not like-kind, IRC 1031(f). But if the property is held for 2 years then it is like-kind. Thus, you can do an exchange with a related party [IRC 267(b)], if the 2-year holding rule is met.

Requirement: HELD FOR INVESTMENT OR BUSINESS USE - In a nutshell, both the relinquished and replacement properties must be *held* for investment or business use for a period of time and during this period the properties must not be held for resale or personal use. Internal Revenue Code Section 1031(a)(1). More specifically this (not-so-clear) requirement means the following:

- (1) RENTAL, BUSINESS OR INVESTMENT USE - You must use the properties as a *rental* property, or for your own *business-use*, or as

an *investment* such as land. {These uses were discussed previously under the like-kind requirement}.

(2) NOT PERSONAL-USE - You must *not* use the properties for personal use (except for the 14-day\10% exception under the vacation home provisions of IRC 280A. See Chapter 27, Part B).

A principal residence, used as such, does not qualify for a 1031 exchange. Principal residences, meeting the ownership and use provisions of Section 121, can permanently exclude taxable gains with the \$250,000 exclusion for single taxpayers and \$500,000 exclusion for married filing jointly, IRC 121. See the special home-owner exclusion reports on the Goldmine forms disk, GMSR1 and GMSR2.

A second or vacation home, used as such (personally), does not qualify for 1031 tax-free treatment. They could qualify for 1031 treatment if they are converted to rental use under special rules.

(3) NOT INVENTORY OR PRIMARILY FOR SALE - You must *not* hold the properties as *inventory* for *immediate* sale to customers, such as a “dealer” would. An example of those who would be "dealers" in real estate are builders, developers and subdividers who are in the business of selling their property as “inventory” to customers in the normal course of their business. IRC 1221(1). You must not hold the properties "primarily for sale" with pre-intent to sell [*Ethel Black*, 35 TC 90, 1960].

(4) CONSISTENCY OF OWNERSHIP, RELINQUISHED PROPERTY TO REPLACEMENT PROPERTY - According to IRS, there should be *consistency of ownership* from the relinquished property to the replacement property without any changes for a one- or two-year period. The IRS has ruled that changes of ownership that are proximate to an exchange violate this holding requirement and therefore cause the exchange to be disqualified, IRS Revenue Rulings 75-292 & 77-337.

However, IRS rulings do not have the force or effect of law, plus there are several tax courts cases that disagree [*Bolker*, 81 TC 782 (1983); *Mageneson*, 81 TC 767 (1983)]. Moreover, partners can elect out of

partnerships and become tenants-in-common, IRC1031 (a). Despite this you should try to maintain consistency of ownership. Ideally, this consistency of ownership from the relinquished property to the replacement property should be maintained without any changes for at least six months to a year. Again, if you do not maintain such ownership consistency you still have a defensible position based on the above.

NOTE – SINGLE MEMBER LLC: According to IRS, transfer of property to a single-member LLC does not violate this holding requirement and should qualify without IRS controversy, IRS Private Letter Ruling 9807013.

(5) HOLDING PERIOD – HOW LONG MUST REAL PROPERTY BE HELD?

Although there is this fundamental holding *requirement*, we do not have an objective (safe harbor) time requirement for a holding *period*. We can only look to scant precedent for some guidance. In an IRS letter ruling, the IRS ruled that a 2-year holding period would be sufficient to meet this holding period test [IRS letter ruling 8429039]. However, IRS rulings do not have the force or effect of law, plus there are tax court cases where much less time was sufficient (*see the second note below). Conventionally, many advisors believe there should be *at least* a one to two year holding period. If you hold the property for one year, try to at least overlap into two “tax years”. Again, according to IRS, the longer you hold the properties the better.

NOTE ON CONVERSION TO PERSONAL-USE: After this holding period, you should be able to convert the real property from investment-use to personal-use without triggering the deferred taxes.

***NOTE ON PROPERTIES QUICKLY SOLD:** Exchanges of quick sales (“flips”) could violate this exchange “holding requirement”. However, in certain situations and with advanced planning, these still may qualify.

Additional Resources

To implement easily using our forms & systems:

The LLC Master Machine by Albert Aiello & Bill Noll. For more info go to <https://TractionREIA.com/al>

The Renaissance Goldmine of Goldmine of Brilliant Tax Strategies Real Estate Investor's, A Tax Reduction Software System by Albert Aiello & Bill Noll. For more info go to <https://TractionREIA.com/al>

Equity Stripping Excel by Albert Aiello & Bill Noll. For more info go to <https://TractionREIA.com/al>