Understanding 1031 Exchange

1031 Exchange

A 1031 Tax Deferred Exchange allows real estate investors to defer the payment of capital gain taxes when selling an investment property and exchanging into another investment property. There are several types of exchanges available and many rules to follow to qualify for the tax deferral.

Exchange Types

Investors have the ability to structure their exchanges in several ways. Depending on the investor's situation any of the four exchange types listed below could be a viable option:

1. Simultaneous Exchange
In a simultaneous exchange the relinquished property is sold and the replacement property acquired on the same day, with concurrent closings. The simultaneous exchange is rare and investors should still use an Exchange Accommodator when doing a simultaneous exchange.

2. Delayed Exchange
The most common method of exchanging, the delayed exchange, allows investors to sell a property and then acquire replacement property within 180 days.

3. Reverse Exchange
The reverse exchange allows investors to acquire replacement property prior to selling. The reverse exchange can be more complicated however, as both the new replacement property and (soon to be) relinquished property can not be owned at the same time. Asset Exchange Company, as an Exchange Accommodating Titleholder will need to go on title to one of the two properties involved in the exchange. Investors considering a reverse exchange should contact Asset Exchange Company well in advance (2 weeks) of closing on the replacement property. For more information about the reverse exchange, please call 813-999-2524 for a free consultation.

4. Construction/Improvement Exchange
The construction exchange allows investors to use exchange proceeds to build on land or improve an existing property. The construction/improvements exchange is often used to

acquire a 'fixer' and do improvements on the existing structure. The pitfall with a construction/improvement exchange lies in the fact that all exchange funds need to be spent on or before the 180th day of the exchange.

Basic Exchange Guidelines

Strict adherence to the guidelines set forth within the tax code is required for a successful exchange. Investors should be aware of four basic requirements when entering into a delayed exchange, and should seek the advice of their tax accountant or attorney to ensure proper adherence to the tax code. The four basic requirements for a successful exchange are:

1. Property Qualifications
The internal revenue code requires that the properties involved in an exchange must be held for productive use in trade or business or for investment, and they must be "like -kind".

The "like-kind" requirement is often a source of confusion for investors. All real estate is like-kind, with the exception of real estate outside the United States.

For example, provided the properties are within the U.S., an investor selling a rental home can exchange into a four-plex. Similarly, an investor selling a warehouse can exchange into a percentage interest in an office building.

Dealer property, or property held as inventory does not qualify for an exchange. The most important factor in determining whether a property is dealer property or inventory is "intent". Upon an audit the IRS will take a careful look at what the investor intended to do with the property at the time of acquisition. If the IRS feels that the intent of the investor was to quickly resell the property, it could be considered dealer property, or inventory, and ineligible for exchange.

2. Timeline
The IRS provides a maximum of 180 days to complete an exchange. The timeline begins upon the close of escrow (COE) of the relinquished property. The replacement property (or properties) must be acquired on or before midnight of the 180th day. No Exceptions! In addition the IRS requires that all potential replacement property be identified by midnight of the 45th day.

If the replacement property (or properties) can not be acquired on or before day 180, the exchange will fail and taxes must be paid.

3. Identification Rules
Identification of all potential replacement property is required on day 45 of the exchange. Identification must be in writing and the description of the properties must be unambiguous. The IRS provides two rules for identifying replacement property:

- **The 3 Property Rule:**
  The 3 Property Rule allows for identification of any three properties, of any price, anywhere in the United States.
- **The 200% Rule:**
  The 200% Rule is an option for identifying more than three properties. With the 200% Rule four or more properties can be identified, however the combined value of all properties identified can not exceed 200% of the property sold.

  For example: Investor A sells a rental home for $500,000. Investor A can identify ten $100,000 rentals, five $200,000 rentals or any combination of properties, provided the aggregate value does not exceed $1,000,000.

4. 100% Tax Deferral
To defer 100% of the capital gain tax liability, two requirements must be met:

A. Reinvest all the cash that was generated from the sale of the relinquished property and;

B. Purchase property equal or greater in value to the net sale price of the relinquished property.

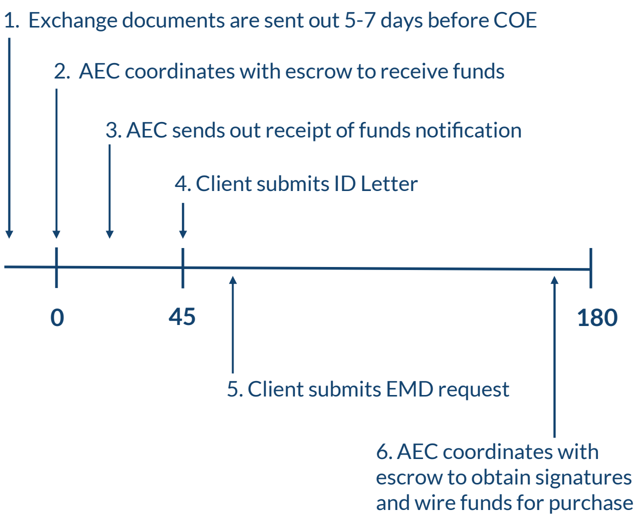
The two requirements listed above can be accomplished in a variety of ways. For example, an investor selling a $500,000 rental, with $200,000 in equity, can purchase two $300,000 properties with a $100,000 down payment on each.

A partial exchange is also possible. A partial exchange occurs in a trade down situation, where the replacement property is of less value than the relinquished property (i.e. sell for $500,000 buy for $400,000). A partial exchange will result in a partial deferment of the tax liability.

Note: Net sale price = Sale price less non-recurring closing costs.

The Exchange Process: Step by Step

The graphic below illustrates the steps involved in the 1031 Exchange process once an account is opened. Please note, the 1031 Exchange account should be opened shortly after escrow is opened.



Note: **COE** = Close of Escrow
EMD = Earnest Money Deposit

About Asset Exchange Company

Asset Exchange Company is a leading provider of 1031 Exchange accommodation services. Choosing Asset Exchange Company as your exchange accommodator ensures:

Attorney Guarantee™
Asset Exchange Company is the only company in the industry offering a guarantee that all exchange documents are prepared and reviewed by a licensed attorney. A sound exchange agreement drawn, prepared and reviewed by a licensed attorney can be your best defense in the event of an IRS audit.

Funds Security
Exchange funds are deposited into individual FDIC insured trust accounts with leading financial institutions. Client exchange funds are never commingled with operating funds and Asset Exchange Company also carries substantial Errors and Omissions insurance and maintains a Fidelity Bond for added protection.

Integrity and Experience
Asset Exchange Company sets the standard for integrity and experience within the industry. Asset Exchange Company's extensive knowledge, attention to detail and expert guidance provide customers the highest level of service available in the industry.

Fair and Honest Pricing
With Asset Exchange Company there are never any hidden fees, layered costs or miscellaneous service charges.

Contact Asset Exchange Company

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