



## Understanding 1031 exchange

### Tax Benefits of Exchanges

Whether the investor's property is owned free and clear or encumbered, the benefits of a tax deferred exchange are significant. The tax dollars saved by doing an exchange can be utilized to purchase additional investment property. Compare a sale versus an exchange.

Assume the following:

- Investor sells property with no debt for \$1,000,000
- Basis is \$500,000
- The property has been held in excess of 12 months
- Capital gain is \$500,000 (\$100,000 from recapture of depreciation deductions and \$400,000 from appreciation in value)
- Current federal tax rate for an individual is 15% on appreciation and 25% on depreciation recapture (corporations are taxed at a higher rate)
- Investor's state tax rate is 9% (federal deduction for state taxes is not included).

	Exchange	Sale
Net Equity	\$1,000,000	\$1,000,000
Capital Gain Tax	\$None	\$ 130,000
Equity to Reinvest	\$1,000,000	\$ 870,000
Acquisition Value*	\$3,333,000	\$2,900,000

\*Assume 30% Down

Result: The investor who exchanges is able to defer the capital gain tax and purchase replacement property worth \$433,000 more than the investor who sells and reinvests with after-tax dollars.

### Non-Tax Benefits of Exchanges

In addition to deferring the capital gain tax, tax deferred exchanges provide the investor with a wide range of non-tax opportunities to suit the investor's portfolio:

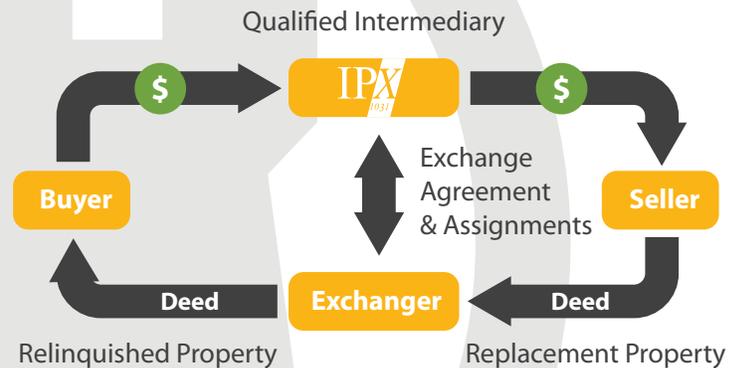
- Reposition assets
- Change property types
- Increase leverage
- Increase depreciation deduction
- Reduce management obligations
- Provide for estate and retirement planning
- Allow for relocation
- Improve cash flow
- Achieve property consolidation or diversification
- Eliminate or create joint ownership

- Defer phantom gain on problem properties
- Construct improvements on a property

### What is "Like-Kind" Property?

To qualify as "like-kind" property for a §1031 exchange the investor's relinquished and replacement properties must be property that has been and will be held for productive use in the investor's trade or business or for investment. The followings are some examples:

- OFFICE to MANUFACTURING
- 30-YEAR LEASES to VACANT LAND
- RETAIL to APARTMENTS
- AGRICULTURAL LAND to MIXED-USE (investment & personal use)
- DUPLEX/FOURPLEX to RENTAL HOUSES



### Delayed Exchange Flowchart



### The Exchange Process

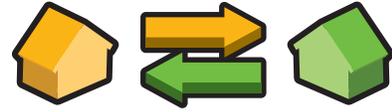
An exchange is rarely a swap of properties between two parties. Most exchanges, whether they are simultaneous or delayed, involve three parties: the investor (exchanger) who is doing the exchange, the buyer who is purchasing the exchanger's old (relinquished) property and the seller who is selling the exchanger a new (replacement) property. To create the exchange of assets and to obtain the benefit of

the "Safe Harbor" protections of the tax code to prevent actual or constructive receipt of the exchange proceeds, which would disqualify the exchange treatment, prudent exchangers use the services of a "Qualified Intermediary". The Qualified Intermediary, becomes a fourth party principal in both simultaneous and delayed exchanges. As illustrated in the above diagram, the steps for completing an exchange with IPX1031 are relatively simple.

- The exchanger signs a contract to sell a relinquished property to the buyer.
- IPX1031 and the exchanger enter into the exchange agreement to retain IPX1031 as the Qualified Intermediary and the exchanger assigns the exchanger's rights in the sale contract to IPX1031, including the right to receive the exchange funds.
- At the closing of the relinquished property the exchange funds are wired to IPX1031 and IPX1031 instructs the settlement officer to transfer the deed directly from the exchanger to the buyer.
- The exchanger has a maximum of 180 days in the exchange period (or until the tax filing deadline, including extensions, for the year of the sale of the relinquished property), to acquire all replacement property.
- Unless the exchanger can acquire all replacement property within the first 45 days from the close of the relinquished property, the exchanger must identify possible replacement properties in writing to IPX1031 within the 45-day identification period.
- The exchanger signs a contract to purchase the replacement property with the seller and the exchanger assigns the exchanger's rights in the purchase contract to IPX1031.
- At the closing of the replacement property IPX1031 wires the exchange funds to complete the exchange and IPX1031 instructs the settlement officer to transfer the deed directly from the seller to the exchanger.

## §1031 Exchanges - An Overview

1031 exchanges provide investors with one of the best tax strategies for preserving the value of an investment portfolio. By using an exchange the investor is able to defer the recognition of capital gain taxes that would otherwise be incurred on the sale of investment property. The investor can then use the entire amount of the equity to purchase substantially more replacement property. To qualify as an exchange the relinquished and replacement properties must be qualified "like-kind" properties and the transaction must be structured as an exchange.



### Internal Revenue Code §1031

"No gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like-kind which is to be held either for productive use in a trade or business or for investment."

## Exchange Requirements

Relinquished Property

Replacement Property



As a general rule of thumb, to avoid paying any capital gain taxes in an exchange, the investor should always attempt to gain taxes:

1. Purchase equal or greater in net sales price (value).
2. Reinvest all of the net equity in replacement property.
3. Obtain equal or greater debt on replacement property. Exception: A reduction in debt can be offset with additional cash from exchanger, but increasing debt cannot offset a reduction in exchange equity.

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