

the BOTTOMLINE & BASICS on 1031 Exchange Real Estate Transaction

Performing a 1031 tax-deferred exchange (1031 real estate exchange) in Phoenix-Scottsdale-Tempe-Paradise Valley-Tucson (Arizona) is a lot simpler than it used to be says real estate agent Juan/John Pesqueira at Attorneys Realty. Still, there are important things that you should know and as your real estate agent I will make sure that you are provided the highest level of service to your 1031 exchange. Say you found a property (ies) One of the most common, and perhaps most significant, questions that is often asked is, “What language do I need to include in the purchase and sale agreement?”

There are two main things that you should always check for in the purchase and sale agreement to protect yourself in a 1031 exchange. First, make sure that the purchase and sale agreements on both the relinquished and replacement properties are assignable, **so that a qualified intermediary may “step into your shoes” to successfully perform the exchange. Second, include language in the purchase and sale agreements or addendums that establishes your intent to perform a 1031 tax-deferred exchange**

There is no specific language that is required, but here are a couple of examples of what many of our investors use:

Sale of Relinquished Property

Buyer is aware that Seller intends to perform a 1031 tax-deferred exchange pursuant to Section 1031 of the Internal Revenue Code. Buyer accordingly agrees to an assignment of the rights under this contract by the Seller to First American Exchange Company, a Qualified Intermediary. Buyer agrees to cooperate in such exchange at no cost or liability to Buyer.

- *We use First American Exchange Company but you have options to choose your own 1031 exchange company to hold the funds at close of escrow and distribute once a property has been acquired...*

Purchase of Replacement Property

Seller is aware that Buyer intends to perform a 1031 Tax Deferred Exchange pursuant to Section 1031 of the Internal Revenue Code. Seller accordingly agrees to an assignment of the rights under this contract by the Buyer to First American Exchange Company (insert exchange company if differ), a Qualified Intermediary. Seller agrees to cooperate in such exchange at no cost or liability to Seller.

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- *We use [First American Exchange Company](#) but you have options to choose your own 1031 exchange company to hold the funds at close of escrow and distribute once a property has been acquired...*

Similar language will also appear in the exchange instructions that you will sign to further establish your **client's intent to perform the exchange**.

Our partners at [First American Exchange](#) (or the 1031 exchange company you use) will coordinate with your closing agent and prepare and provide escrow with four documents that are required to create the exchange:

1. Exchange Instructions;
2. Exchange Agreement;
3. Assignment of the Purchase Contract (signed by your client) and
4. Notice of Assignment (signed by both the Buyer and the Seller).

Completing a 1031 exchange requires the appropriate documentation; at [First American Exchange](#) they will help you with that process for a successful exchange.

Equal or Greater in Value and Equity

One of the most common questions we receive from taxpayers who plan to do a **1031 exchange** is **"How much do I have to buy in order to defer my taxes?"**

While **it's important to have your tax advisor weigh in on this**, there is a shorthand way to figure out whether the purchase you are contemplating will be enough to successfully complete your exchange.

To structure a fully tax deferred exchange, you must do two things. First, you must acquire replacement property that is equal to or greater in value than the relinquished property you disposed of. In addition, you must use up all of the net cash that you get from the sale and invest it in the new property.

For example, if you are selling a property in Phoenix, Scottsdale, Paradise Valley, Tempe, Mesa, Glendale, Chandler, Gilbert, Peoria, Tucson, or anywhere in Arizona for \$500,000 that is subject to debt in the amount of \$300,000, you need to acquire property that is worth at least \$500,000 and you must invest all of the net proceeds (\$200,000) into the new property. The balance of the \$300,000 in debt can be replaced either by debt on the new property or by investing additional cash.

Trading Down

If you fail to both acquire something that is equal to or greater in value than the relinquished property and invest all of the net cash from the relinquished property

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into the replacement property, does that completely ruin your exchange? The answer to this question depends on the deal you are attempting to do. If you trade down too much in value or equity, it may not be worthwhile to do an exchange. As mentioned above, it is * important to have your tax advisor review your numbers*, but it may be that you are able to defer some tax but will also owe some tax on the transaction.

If you trade down in either value or equity, the short hand way to compute how much tax you would owe would be that the greater of the trade down in value or trade down in equity would be your taxable gain.

Let's look at the following example:

Relinquished Property	Replacement Property
Sale Price: \$500,000 Debt: \$300,000 Equity: \$200,000	Sale Price: \$450,000 Debt: \$350,000 Equity: \$100,000

In this example, the taxpayer buys property worth \$50,000 less, borrows more and invests \$100,000 less in the replacement property. The taxpayer is trading down in value by \$50,000 and trading down in equity by \$100,000, and therefore would need to pay tax on \$100,000. If \$100,000 is less than the actual gain the taxpayer would have if he sold the property outside of an exchange, he would still have a good reason to do an exchange.

Exchange Expenses

Some expenses paid at a closing reduce the amount that you need to invest in **the replacement property. These are called “exchange expenses” and most tax advisors agree that they include broker’s commissions, title, escrow, exchange fees and transfer taxes, among other costs.**

If you would like more information about the 1031 exchange requirements, or you would like to set up a 1031 exchange, please contact us our partners at [First American Exchange](#) and we would be happy to help you.

THE BOTTOM LINE ON 1031



Section 1031 of the Internal Revenue Code gives investors the ability to defer capital gains and the recapture of depreciation on the exchange of business-use or investment property for another business

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use or investment property. If you are selling property used for business use or investment, an exchange may be an excellent tax strategy to help you grow your investment portfolio.

PURPOSE

- Defer payment of capital gain taxes

LIKE-KIND REAL ESTATE

- Properties must be like-kind (real estate for real estate)

INVESTMENT REQUIREMENT

- Properties must be held for investment or in connection with a trade or business, but do not have to be similar in use (exchange raw land for apartment building)

EXCHANGE TRANSACTION

- **There are two parts to the transaction: “transfer” of relinquished property and “acquisition” of replacement property**

SAME TAX PAYER REQUIREMENT

- The taxpayer must acquire title to the replacement property in the same manner as title was held in the relinquished property; there are some exceptions to the rule, such as entities that are disregarded for tax purposes

DEADLINES

- There are two deadlines, both of which began on the date of transfer of the first relinquished property:
 1. Replacement property (ies) must be obtained within 45 days
 2. The exchange must be completed by the earlier of:
 3. 180 days from the first relinquished property closing, or
 4. The due date of the tax payer federal income tax return together with all extensions

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IDENTIFICATION RULES

- Replacement property must be unambiguously described, made in writing, and signed by the tax payer. The two most common identification rules are:
 1. 3-property RULE– up to three properties can be identified without regard to their fair market value
 2. 200% RULE – any number of properties can be identified without regard to their fair market value does not exceed 200% of the fair market value of all relinquished property

FULLY DEFERRED EXCHANGE

- Many criteria must be met in order to have a fully deferred exchange. Generally:
 1. Taxpayer must buy replacement property(ies) of greater or equal value
 2. Taxpayer must reinvest all proceeds from the sale of the relinquished property into the replacement property(ies)
 3. Taxpayer must re-acquire debt equal or greater to debt paid off from the relinquished property (or replace the debt with additional cash)

We are the go to 1031 exchange real estate agents in Phoenix, Scottsdale, Tempe, and throughout Arizona. We have a team of certified experts who will draw up the legal paperwork, guide you through the process, and make sure the transaction is smooth from start to finish.

For a successful 1031 exchange, it is important to understand and comply with the 1031 exchange identification rules. These rules are not that complicated, but a failure to follow the rules may ruin your exchange. Here are the top ten things to remember when identifying replacement property in an exchange:

1. **Deadline and General Rules.** The taxpayer has 45 days from the date that the relinquished property closes to identify the replacement property that he intends to acquire in the exchange. If there is more than one relinquished property in one exchange, the 45 days are measured from the date the first relinquished property closes. The property identified does not have to be under contract, and the taxpayer does not have to acquire everything that he identifies. It is important to note, however, that the taxpayer is not allowed to acquire anything other than the property that he

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- has identified, and a failure to comply with the identification rules can ruin the whole exchange.
2. **3 Property Rule.** There are rules that limit how many properties the taxpayer may identify. In most cases taxpayers use the three property rule. The taxpayer may identify up to three replacement properties and may acquire one, two or all three of those.
 3. **200% Rule.** If the taxpayer wants to identify more than three properties, he can use the 200% rule. This rule says that the taxpayer can identify any number of replacement properties, as long as the total fair market value of what he identifies is not greater than 200% of the fair market value of what was sold as relinquished property. First American Exchange recommends **that taxpayers build in a “cushion” by identifying properties that are worth less than what is permitted**, in case some properties are later determined to have a higher value than what was originally estimated.
 4. **95% Rule.** There is another rule that is not commonly used by investors. The 95% rule says that a taxpayer can identify more than three properties with a total value that is more than 200% of the value of the relinquished property, but only if the taxpayer acquires at least 95% of the value of the properties that he identifies. Essentially, the taxpayer will need to acquire everything that he has identified to make this work, and that is why it is not relied on too often.
 5. **Property Acquired in 45 Day Period.** Any property that is actually acquired during the 45-day identification period is deemed to be properly **identified. It's important to note that if some property is acquired during this period and some property is acquired later using another one of the identification rules, the property acquired during the first 45 days needs to be counted as one identified property.** For example, if you acquire one property during the first 45 days and you plan to use the 3 property rule and buy more properties after the 45 days, you only have two more properties to identify because you have already used up one.
 6. **Manner of Identification.** The identification must be in writing and signed by the taxpayer, and the property must be unambiguously described. This generally means that the taxpayer identifies either the address of the property or its legal description. A condo should have a unit number, and if the taxpayer is buying less than a 100% interest, the percentage share of what is being acquired should be noted.
 7. **Who Must Receive the Identification?** The taxpayer must send the identification notice either to: 1) The person obligated to transfer the replacement property to the taxpayer (such as the seller of the replacement property) or; 2) **To any other person “involved” in the**

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exchange (such as the qualified intermediary, escrow agent or title company), other than a “disqualified person,” such as an agent or family member of the taxpayer. Most identification notices are sent to the qualified intermediary.

8. Replacement Property Must Be Same as What Was Identified. The taxpayer must receive “substantially the same” property as he identified. The regulations contain four examples to illustrate what “substantially the same” means. In one example, the taxpayer identifies two acres of unimproved land and then acquires 1.5 acres of that land. The property acquired is substantially the same because what the taxpayer received was not different in nature or character from what was identified, and the taxpayer acquired 75% of the fair market value of the property identified. In another example, the taxpayer identifies a barn and two acres of land, and then acquires the barn with the land underlying the barn only. The IRS says that the property acquired was not substantially the same as the property identified because it differed in its basic nature or character.
9. Property to be Constructed. If the replacement property is under construction at the time of identification, the taxpayer must include not only the address or legal description of the property, but also must include a description of what is to be constructed on the property.
10. Reverse Exchanges. If the taxpayer is doing a reverse exchange where the accommodator acquires the replacement property before the taxpayer closes on the sale of the relinquished property, the taxpayer must identify in writing what he intends to sell and that identification must be sent no later than 45 days after the accommodator closes on the replacement property.

*A **1031 exchange** is a tax-deferred **exchange**, not a tax-free **exchange**. If you complete a **1031 exchange**, you can defer the capital gains taxes on the sale of your existing **property**. However, if you later **sell** the replacement **property**, you will have to pay capital gains taxes (if you in fact have a capital gain). the internet...*

If you have any questions about the identification rules, please contact us or our partners at First American Exchange and we would be happy to assist you. We advise you speak to your CPA first (certified public accountant), then **contact us...**

The info above is provided by First American Exchange

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