

## EXCHANGE BASICS / FAQs



### Q. WHAT IS AN IRC §1031 TAX DEFERRED EXCHANGE?

A. Exchanging has been around for centuries. Bartering is a form of exchange. The Internal Revenue Service established a clear-cut (some of the time) manner in which a taxpayer may sell a property held for investment or productive use in a trade or business and reinvest the proceeds into another "like-kind" property without obligation for payment of capital gain tax. For the investor, this can allow protection, growth, and diversification of assets, among other benefits.

The theory behind Section 1031 is that when a property owner reinvests sale proceeds from one property into another property, the economic gain has not been realized in a way that justifies a tax. Put another way, the taxpayer's investment has not changed; just the form of the investment has changed (e.g., raw land exchanged for commercial building). Thus it would not be fair to tax the property owner on what amounts to a "paper" gain.

### Q. WHAT ARE SOME OF THE QUALIFICATIONS TO HAVE A VALID EXCHANGE?

A. Here are the basics:

**Property**—Real property held for investment or used in a trade or business. Personal property used in a trade or business can also qualify for an exchange, but greater restrictions apply. Some examples of property that does not qualify for a 1031 exchange are: stocks, bonds, partnership or LLC interests, personal residences and stock in trade or inventory.

**Qualified Use**—Both the property being sold (the "relinquished" property) and the property being purchased (the "replacement" property) must be held for investment or productive use in a trade or business. Property acquired with the intention of quick resale does not qualify for 1031 treatment.

**Like Kind**—Once past the qualified use test, we can address the "like kind" test. Fortunately, this test is more black and white: Real property in the United States is "like kind" to real property in the United States. (Real property in a foreign country is not considered like-kind to US real estate.) Real property that is eligible for 1031 treatment includes single-family homes, multifamily properties, farmland, commercial office buildings, shopping centers, raw land, hotels, factories, leases of 30 years or more, quarries, and oil fields. Essentially, any type of real estate may be traded for another type of real estate as long as it satisfies the qualified use test. "Like kind" rules for personal property are significantly more restrictive. Iowa Equity Exchange can address questions about personal property exchanges.

**Exchange Requirement**—The IRS has established specific paths one should follow to ensure a proper exchange. For instance, the property owner cannot simply sell his or her property and use the proceeds to purchase new property. The investor must follow IRS guidelines, which prohibit the "actual or constructive receipt" of the proceeds of the sale of the relinquished property. The primary "safe harbor" provided by the IRS for receipt and holding of those funds is through the use of a Qualified Intermediary (QI) such as Iowa Equity Exchange.

### Q. WHAT IS THE PURPOSE OF THE QUALIFIED INTERMEDIARY (QI)?

A. The purpose of the Qualified Intermediary can be summarized by saying that a QI's primary obligation is to assist his or her client, the taxpayer, in achieving an exchange that is either fully within the safe harbors created by the IRS for exchanging, or is as impervious to scrutiny by the IRS as possible if conducted outside those safe harbors. (The vast majority of exchanges are conducted within the IRS's safe harbors.) Through the use of a written agreement with the client, the Qualified Intermediary receives the funds from the sale of the relinquished property and holds them in trust for the client. When the replacement property has been identified and closing is to take place, the QI releases those funds for the purchase of that property. Through the receipt, holding, and disbursement of the client's funds, the QI allows the client to avoid "actual or constructive receipt" of those funds and preserves one of the aspects of a successful exchange.

### Q. WHAT DOES THE QUALIFIED INTERMEDIARY DO WITH THE FUNDS WHILE THEY ARE IN HIS OR HER POSSESSION?

A. This is an excellent question and it will serve to set out one of the important differences between Iowa Equity Exchange and some other QI firms. Some firms "pool" their clients' funds; some even commingle clients' funds with their firms' funds. In both cases, those QI firms have created the possibility of loss of client funds through potential lawsuits or other actions. At Iowa Equity Exchange, a separate and strictly segregated account is created in the client's name for the holding of the

funds for each exchange we handle. Funds are deposited into one of Iowa Equity Exchange's partner banks and earn a generous and competitive interest rate for the benefit of the client. In many cases, the interest earned during the term of the exchange more than pays Iowa Equity Exchange's exchange fee. To further put the client's mind at ease, the account is viewable online 24/7.

#### **Q. WHY MUST THE SALE PROCEEDS GO TO THE QI?**

A. The Qualified Intermediary is a safe harbor established by the Treasury Regulations in order to avoid taxable receipt of funds. If the taxpayer stays within the requirements of this safe harbor, the IRS will not consider the taxpayer to be in receipt of the funds. To do otherwise would cause the exchange to fail.

#### **Q. CAN A TAXPAYER HAVE HIS OR HER BROTHER (LAWYER, ACCOUNTANT, ETC.) SERVE AS MY QUALIFIED INTERMEDIARY?**

A. The QI must be an entity that is not an agent of the taxpayer or a Disqualified Person for purposes of a 1031 exchange. Examples of a Disqualified Person are the actual taxpayer or the taxpayer's accountant, attorney, real estate professional, financial planner, employees, partners or close relative.

#### **Q. IS IT BEST TO HAVE A QUALIFIED INTERMEDIARY WHO IS A LAWYER OR A CPA SO HE OR SHE CAN PROVIDE LEGAL OR ACCOUNTING ADVICE, TOO?**

A. A Qualified Intermediary is specifically prevented from offering legal or accounting advice while acting as a QI. In fact, if a QI who is a lawyer or a CPA has provided legal or accounting services to a taxpayer during the two years prior to functioning as a QI in an exchange, the exchange will fail. In that case, the lawyer or CPA would be classified as a Disqualified Person and would not be eligible to serve in the QI capacity. The principal of Iowa Equity Exchange is a real estate investor and not an attorney or a CPA, thereby precluding potential scrutiny by the IRS for legal or accounting advice.

#### **Q. WHAT CONSIDERATIONS SHOULD BE MADE WHEN CHOOSING A QUALIFIED INTERMEDIARY?**

A. Integrity. Precision. Security. It's not just a clever tagline at Iowa Equity Exchange-it is the way we do business. It is critical to the success of your exchange to find a Qualified Intermediary who operates with those criteria at the forefront.

Integrity is of extreme importance. You must be confident that the QI you hire will operate with the utmost of integrity.

Precision is crucial in properly documenting the exchange process and in monitoring the stringent time requirements of an exchange.

Security is essential to protect your funds while they are in the possession of the Qualified Intermediary.

How can you be sure you are engaging a Qualified Intermediary who stays abreast of current laws that affect the exchange process, one who carries out his duties with integrity and precision, and provides the highest security for your funds? One way is to make sure the QI belongs to the Federation of Exchange Accommodators, the only national trade association organized to represent professionals who conduct like-kind exchanges under Internal Revenue Code §1031. Iowa Equity Exchange is a member of the FEA and we wholeheartedly support the association's Code of Ethics.

#### **Q. WHAT ARE THE GENERAL GUIDELINES TO FOLLOW IN ORDER FOR A TAXPAYER TO DEFER ALL THE TAXABLE GAIN IN AN EXCHANGE?**

- The value of the replacement property must be equal to or greater than the value of the relinquished property.
- The equity in the replacement property must be equal to or greater than the equity in the relinquished property.
- The debt on the replacement property must be equal to or greater than the debt on the relinquished property.
- All of the net proceeds from the sale of the relinquished property must be used to acquire the replacement property.

#### **Q. ARE THERE SPECIFIC TIME FRAMES THAT MUST BE MET TO COMPLETE A SECTION 1031 EXCHANGE?**

A. Yes, very specific. From the date of closing of the relinquished property, the taxpayer has exactly forty-five (45) days to properly identify potential replacement properties. Also, the taxpayer must complete the exchange (close on the replacement property) within one hundred eighty (180) days from the closing date of the relinquished property. Other time requirements can apply as well. Part of our service at Iowa Equity Exchange is to clearly identify and specify all pertinent dates having to do with the exchange.

#### **Q. WHAT ARE THE RULES REGARDING THE IDENTIFICATION OF PROPERTIES?**

A. There are three rules that address the number of properties that can be identified. The taxpayer may choose the one rule he or she wishes to follow. In the vast majority of cases, the Three-Property Rule will make the most sense.

**The Three-Property Rule** states that the taxpayer may identify up to three properties regardless of their fair market value. The taxpayer may purchase one, two, or all three of the identified properties.

**The 200% Rule** says that the taxpayer may identify more than three properties, but the aggregate of the fair market value of all the properties may not exceed 200% of the gross sale price of the relinquished property.

**The 95% Value Rule** states that any number of properties may be identified, but the taxpayer must purchase at least 95% of the fair market value of all of the identified properties.

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### Q. CAN A SINGLE PROPERTY BE EXCHANGED FOR MULTIPLE PROPERTIES, OR VICE VERSA?

A. Yes. A taxpayer can diversify his or her investments from a single property to two or more replacement properties. Conversely, several properties currently owned by a taxpayer could be exchanged into one larger property.

### Q. CAN A TAXPAYER KEEP SOME OF THE PROCEEDS FROM THE SALE OF THE RELINQUISHED PROPERTY, OR DOES IT ALL HAVE TO GO INTO THE REPLACEMENT PROPERTY?

A. Some cash can be retained, but the taxpayer will be taxed on anything he or she keeps. In exchange terms, this is called "Taxable Boot." There are complex regulations on how and when funds may be received. The qualified intermediary must create the proper documentation and disbursement controls to allow for the partial release of cash. If this is not done properly the exchange will fail and tax will be owed on 100% of the gain!

### Q. IF A TAXPAYER HAS ALREADY SIGNED A CONTRACT TO SELL HIS OR HER PROPERTY, IS IT TOO LATE TO START A TAX-DEFERRED EXCHANGE?

A. No. If the taxpayer has not transferred title, or the benefits and burdens of the relinquished property, he or she can still begin a tax-deferred exchange. After the closing has occurred, it is too late to take advantage of a Section 1031 tax-deferred exchange (even if the taxpayer has not cashed the proceeds check).

### Q. WHAT IF A TAXPAYER HAS SIGNED AN AGREEMENT TO SELL A PROPERTY AND ACCEPTED AN EARNEST MONEY DEPOSIT?

A. Again, if closing has not occurred, it is not too late to begin a tax-deferred exchange. The earnest money can be transferred to the QI and the exchange can proceed.

### Q. CAN A TAXPAYER PURCHASE THE REPLACEMENT PROPERTY BEFORE SELLING THE RELINQUISHED PROPERTY?

A. Yes. This process is called a "Reverse Exchange," and can also qualify for 1031 tax-deferred treatment. This is a more complicated and specific process than a standard exchange. Although the Treasury Regulations technically do not apply to reverse exchanges, the IRS issued "safe harbor" guidelines for reverse exchanges on September 15th, 2000, in Revenue Procedure 2000-37. Compliance with the safe harbor creates certain presumptions that will enable the transaction to qualify for Section 1031 tax-deferred exchange treatment. If you are contemplating a reverse exchange, please contact Iowa Equity Exchange to discuss this type of transaction.

### Q. THIS ALL SEEMS SO COMPLICATED. IS IT WORTH IT?

A. There are times when it can, indeed, get complicated. The competent Qualified Intermediary can make the process relatively simple, however. Whether it is worth it is a question each taxpayer must answer on his or her own through consultation with his or her legal and accounting professionals. Suffice it to say that deferring tens of thousands of dollars in taxes in return for signing a few extra forms and operating within a given time frame is a trade off most investors will willingly and gladly make. Iowa Equity Exchange will capably guide you every step of the way.

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*The professionals at Iowa Equity Exchange understand the complex rules of Section 1031 exchanges. We can help simplify this information for you and your clients. Section 1031 exchanges are our only business. We are members of the Federation of Exchange Accommodators, the only national association that is dedicated to the protection of the consumer in 1031 transactions. Less than 2% of all qualified intermediary service providers nationwide are members of this organization. We can creatively and strategically assist you and your clients with the sale or purchase of assets in order to maximize the tax deferral opportunities. Please contact us at your convenience.*



*Note: Per 1031 regulations, Iowa Equity Exchange cannot give tax and/or legal advice. Every taxpayer should review specific transactions and potential tax consequences with his or her personal tax and/or legal advisor.*