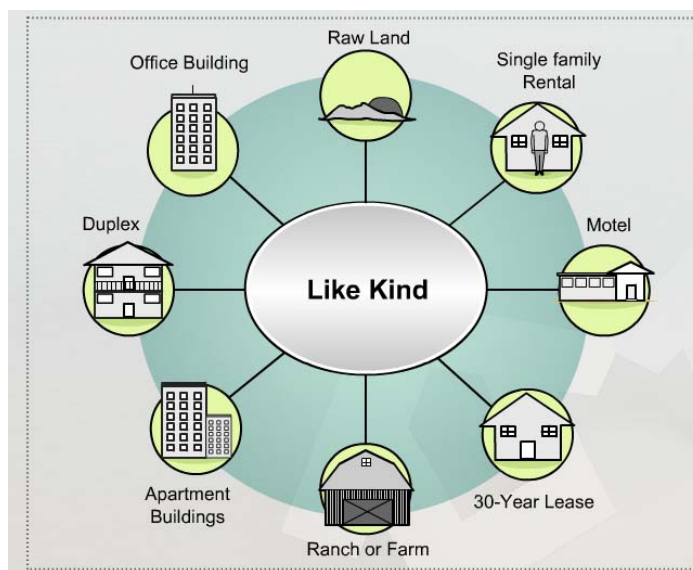


2-Minute Reference Guide to §1031 Exchanges

- ❖ **Basic §1031 Rules.** Internal Revenue Code Section 1031 permits the deferral of capital gains taxes on the sale of property held for investment or productive use in a trade or a business. In a Forward Delayed Exchange, the most common type of exchange, property is sold (Relinquished Property), and the proceeds are used to purchase replacement property (Replacement Property) within certain timelines. To qualify for safe harbor tax deferral, the sale proceeds must be held by a Qualified Intermediary between the sale of the Relinquished Property and the purchase of the Replacement Property. §1031 permits deferral of federal capital gains taxes (15%), depreciation recapture (25%), and state taxes (generally 8% to 9% where applicable. The state tax in California is currently 9.3%). The regulations require strict adherence to the following tests:
 - ❖ **Holding Period -- How Long is Long Enough?** There is no hard and fast rule as to the length of time that a replacement property must be used for investment purposes following an exchange before it can be converted from investment use to personal use. Nor is there a fixed test as to how long the relinquished property must be held as an investment property and subsequent sale. The actual measuring stick is a “reasonable time”. In determining what constitutes a “reasonable time”, the courts look at the “intent” of the taxpayer at the time of the original purchase, its conversion and at the exchange, applying a “facts and circumstances” analysis to determine whether such investment “intent” is met. Tax advisors frequently recommend that taxpayers hold the replacement property for at least one year after acquisition, and the relinquished property for at least two years prior to sale, but these time periods constitute no guarantees.
 - ❖ **“Dealer” vs. Investor.** In order to qualify for tax deferral, the taxpayer may not be deemed a “dealer” in the property. If the taxpayer is determined to be a “dealer” his property will be treated as “inventory”, rather than investment property, and not only will the property be disqualified for §1031 treatment, but its sale will also be taxed as ordinary income, rather than capital gains. Whether a taxpayer in a given transaction will be accorded dealer or investor status will be decided based on such facts as: (1) length of time the property is held; (2) the taxpayer’s volume and frequency of sales; (3) his classification of the property on his books and records, and (4) his efforts to subdivide, develop, advertise, or list the property.
 - ⤴ **45 Day Identification Rule:** When the property is sold and title passes to the purchaser, the timing requirements to *identify* and *acquire* the replacement property commence. A written list of **up to three (3)** potential replacement properties should be delivered to the Intermediary. If the taxpayer wishes to identify more than three potential replacement properties, there are only two ways to do this:
 - ⤴ **200% Rule:** More than three properties may be designated if their collective values do not exceed 200% of the fair market value (“FMV”) of the relinquished property; or
 - ⤴ **95% Rule:** An unlimited number of replacement properties may be designated so long as 95% of the fair market value of all properties identified are actually acquired.
 - ❖ **180 Day Acquisition Rule.** The replacement property must be acquired within the earlier of: (1) 180 days from closing of the first sale; or (2) the due date for the tax return for the year of the sale (including extensions).

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- ❖ **Qualified Intermediary.** Unless the exchange is a two-party exchange (the buyer of the relinquished property is providing the replacement property), the Regulations require a neutral Intermediary. The taxpayer may not have access to the sales proceeds at any time during the transaction, and neither may the proceeds be under the direction of anyone deemed an “agent” of the taxpayer. Direct deeds to and from the taxpayer (without naming the Qualified Intermediary) are permitted, however the Qualified Intermediary should be listed as a party on the Settlement Sheet.
- ❖ **“Like-Kind” Real Property.** U.S. real estate used for investment or business purposes is exchangeable for other U.S real estate used for investment or business purposes. This includes cases where fee simple property, partial interests, rental units, shopping centers, condominiums, business properties leasehold interests or even raw land are exchanged for each other, including easy-to-manage triple net leases of 30 years or more, which will provide a steady future stream of income to the taxpayer.



- ❖ **Deferring All the Tax.** Taxpayers are often confused about such issues as: How do I make sure that the transaction is tax-deferred in full? By following just two simple rules, your transaction should meet the full-deferral rollover test of §1031: (1) You must buy a property of equal or greater value to the property sold in order to completely defer the applicable capital gains tax. If you purchase a property of lesser value, you will be taxed on the difference; and (2) You must use all the cash proceeds from the sale of the relinquished property on your purchase of replacement property in order to completely defer capital gains tax. If you do not use all your proceeds on the purchase, you will be taxed on the difference.
- ❖ **Reverse Exchanges.** The purchase contract may be executed prior to the sale of the relinquished property; however the closing on the purchased property cannot precede the closing date of the sale of the relinquished property, *except under limited circumstances*. When the replacement property is received prior to the sale of the relinquished property, this is called a Reverse Exchange. In a Reverse Exchange, an Exchange Accommodation Titleholder (EAT) acquires and holds legal title to the taxpayer's property on their behalf. The Intermediary then facilitates the exchange. The best way to visualize a reverse 1031 exchange is to view it as two separate component parts – each separate of the other and yet fully and contractually integrated.

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Reverse Exchanges (cont.)

The Reverse 1031 Exchange is actually (1) a parking transaction where one of the properties is acquired and held (parked) by the EAT and then (2) a simultaneous 1031 exchange occurs between the Intermediary and the EAT.

- ❖ **Build-Your-Own Replacement Property.** The taxpayer can purchase land and construct his own structures on the replacement property; however this is only permitted by use of the EAT to hold title during construction in a “parking” transaction to qualify for safe-harbor protection. The construction and closing on the replacement property must be completed within the 180 day/close of tax year restriction.
- ❖ **Personal Residences and Vacation Homes.** Both the relinquished and purchased property must be held for investment or trade or business purposes. Thus, personal residences generally do not qualify. In certain circumstances, it is possible to convert a personal residence, or vacation home into an investment property at a later date, or to purchase a residence as the replacement property, and subsequently convert it from investment to personal use. One possible way of *avoiding, rather than deferring gain* on the subsequent sale of property converted from investment use to a primary residence is available by using the §121(a) exclusion of gain on the sale of a principal residence, up to a maximum of \$500,000 (\$250,000 for single taxpayers).
 - The permanent exclusion under §121 requires a special holding period of 5 years in the case of property acquired in a §1031 transaction. Special Rules have been set out for this type of transaction under Code Section 840.
 - A taxpayer desiring to exchange an interest in a vacation home under §1031 should not exceed the personal use limits of Code Section 280A, and should rent the property at a fair rental value at least for the year leading up to the exchange.
- ❖ **Advanced Issues.** Reverse Exchanges (buying before selling), Construction Exchanges (building your own replacement property), Related Party Transactions, Seller Financing (taking back a note rather than cash), Condominium Conversions, and Contract Exchanges (exchanging bare construction contracts or options rather than the underlying property) have complex additional rules that apply. Bayview can assist you with answers and assistance for these transactions.

About Bayview. Bayview Financial Exchange Services LLC (“Bayview 1031”) is a subsidiary of Bayview Financial, L.P. the second largest financial institution based in Florida, with over \$9 billion in assets, and 1,500 employees. Bayview is a recognized leader in facilitating §1031 transactions – exchanges constitute their sole business purpose. Bayview may be reached toll-free at (866) 903-1031, or via the internet at www.bayview1031.com.

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