AN EXPERIENCED EXCHANGER'S GUIDE TO 1031

INTRODUCTION

What has been described as the 'greatest wealth building tool ever developed for real estate investors' has been hiding in plain site within the Internal Revenue Code since 1921. Known currently as a Section 1031 exchange, it allows investment or income property owners with the ability to sell a highly appreciated property and replace it with another, while at the same time deferring all capital gain and depreciation recapture taxes.

While 1031 exchanges don't have to be difficult, there are some key rules and requirements set forth by the IRS for how a proper and compliant 1031 exchange can be completed. Although the rules can seem somewhat arbitrary, they generally tend to be both reasonable and worthwhile with the ultimate prize representing a huge boost to an investor's buying power.

So, for the benefit of real estate investors who might be considering a tax deferred exchange, we polled a number of experienced Exchangers to create the definitive compilation of keys to successful 1031 exchanging.

Accordingly, here they are:

PLAN YOUR EXCHANGE FIRST

Tax deferred exchanging typically involves multiple properties, multiple closing or settlements, and multiple buying and selling transactional logistics being enacted within a very specific time frame. For these reasons it is important to plan your exchange beforehand by anticipating the closing logistics, discussing your exchange with a 1031 expert, and mitigating any potential problems before they have an opportunity to arise.

If you'd like to receive a free 1031 exchange plan which will include the underlying replacement property math, meaning how much property you need to acquire in order to have a totally tax deferred exchange, you may request a free 1031 plan at Fyntex.com/plan.html.

THERE ARE DIFFERENT TYPES OF EXCHANGES DEPENDING UPON YOUR CIRCUMSTANCES.

There are different types of tax deferred exchanges that you may utilize depending on your situation. For instance, you can compete a standard deferred or delayed exchange if you expect to sell an old property and replace it with a new one within 180 days. Or, if you need to add improvements to a new property, you may need to consider an improvement or construction exchange? Likewise, if you find yourself in a situation where you need to buy before you can sell, you'll need to consider a reverse exchange.

While all these various exchange types allow you to exchange investment or income property and still defer capital gain and depreciation recapture taxes, the rules for completing them successfully are often quite different. Remember, the reason the Internal Revenue Service allows you to exchange is because they view your exchange of one property and the replacement with another as simply moving your adjusted cost basis from one property to another.

THE PROPERTIES YOU EXPECT TO EXCHANGE MUST BE CONSIDERED 'LIKE KIND'

The Internal Revenue Service requires that the property you sell, as well as the property you buy must be like-kind. And, like kind means one of two things. Either property held for investment, or property held for income. This would exclude your personal residence.

YOU MUST UTILIZE THE SERVICES OF A QUALIFIED INTERMEDIARY

The IRS requires that your exchange be completed with the assistance of a Qualified Intermediary or facilitator. You should use a well-established firm like FYNTEX, so you know that your exchange documentation will be always be correct and that your exchange funds will be safely held in a specifically restricted 1031 exchange account between the time you sell and the time you buy.

YOU HAVE A TOTAL OF 180 DAYS TO COMPLETE YOUR EXCHANGE

You must complete your sale and purchase within a total of 180 days or whenever your tax return is due. The tax return qualifier means that if you start your exchange late in the year, you might have to file for an extension in order to receive your full 180 days.

YOU MUST IDENTIFY CANDIDATE REPLACEMENT PROPERTIES WITHIN THE FIRST 45 DAYS

While you have a total of 180 days to complete your 1031 exchange, the IRS requires that you identify your candidate or target Replacement Properties within the first 45 days of your exchange period. This identification is usually made to your Qualified Intermediary by completing a form which is kept in your exchange file. Since the 45 day identification period moves so quickly, start looking for new property as early as possible in the process.

THERE ARE SPECIFIC RULES FOR IDENTIFYING THE PROPERTY YOU EXPECT TO ACQUIRE

The IRS requires the use of two rules or one exception for identifying potential Replacement Properties.

The first is the Three Property rule, meaning you may identify up to three properties of any value.

The second rule is the Two Hundred Percent rule, meaning you may identify more than three properties provided all of the properties you identify do not exceed two hundred percent of the value of the property you sold.

The one exception is known as the Ninety-five Percent exception. You may identify more than three properties and more than two hundred percent of total identified property value, provided you acquire at least ninety-five percent of everything you identified.

THERE ARE THREE THINGS YOU MUST DO TO HAVE A 100% TAX DEFERRED EXCHANGE

If you want a completely tax deferred transaction you must do these three things. First, buy Replacement Property which is equal or greater than the net selling price of what you sold. Two, move all your equity from the old property into the new property. And three, replace your debt.

BUY REPLACEMENT PROPERTY AS THE SAME ENTITY IN WHICH YOU SOLD

It is always best to buy as the same entity in which you sold. To change your vesting (to an LLC for example) in the middle of an exchange will create unnecessary risk because the IRS could make a case that your new ownership entity had not seasoned their ownership sufficiently to qualify for deferred gain treatment under Section 1031.

INVESTMENT GRADE REPLACEMENT PROPERTIES, A NEW EXCHANGING TREND

One of the recent trends in tax deferred exchanging involves both the desire and the ability of Exchangers to transition from properties which they actively managed into a more passive ownership role through the purchase of investment grade properties and interests. These interests, which still qualify for deferred gain treatment via a Revenue Procedure from the Internal Revenue Service, are typically available in a structure known as a Delaware Statutory Trust.

The benefits to 1031 Exchangers from DSTs, are similar to those of fee simple ownership where the Exchanger is shown on the grant deed, however in a DST, a trust owns and manages the property for the benefit of those investors who are a part of the trust. This structure was approved for deferred gain treatment under Section 1031 by the IRS in Rev. Proc. 2004-86.

The reason that DSTs have grown in popularity is that 1031 Exchangers can diversify their exchange related equity across several DSTs in various real estate property types and still enjoy the benefits of no management responsibilities, monthly cash flow, full tax benefits, a minimum investment of $50,000, as well as the ability to receive assigned debt from the DST sponsor to offset the debt from their exchanged property.

Here are a few of the keys for acquiring interests in Delaware Statutory Trusts:

DELAWARE STATUTORY TRUSTS ARE AVAILABLE IN VIRTUALLY ANY REAL ESTATE INVESTMENT PROPERTY TYPE

Whether you want to own office, industrial, multi family, storage, healthcare, retail, or hospitality, there is likely a DST for you.

DSTs represent a trust structure created by a sponsor, often a large investment real estate owner or REIT. These sponsors acquire or develop these larger properties, arrange their financing and professional management, and then sell interests to investors and 1031 Exchangers.

YOU MAY SELECT A DELAWARE STATUTORY INVESTMENT BY PROPERTY TYPE AND YOU MAY ACQUIRE MULTIPLE INTERESTS ACROSS SEVERAL DSTS SHOULD YOU DESIRE DIVERSIFICATION

Since investments in Delaware Statutory Trusts are considered securities, they must be acquired through a licensed Broker-Dealer or Registered Investment Advisor. These are representatives or firms which are appropriated licensed to disclose the underlying specifications of the properties as well as the expected financial performance.

The minimum net worth threshold for acquiring an interest in a Delaware Statutory Trust is an annual income of at least $200,000 or a net worth over $1 million, exclusive of primary residence.

THE TYPICAL INVESTMENT TERM FOR A DELAWARE STATUTORY TRUST IS 7-10 YEARS

Most Delaware Statutory Trusts are financed for a ten year period. In addition, the rules underlying the Delaware Statutory Trust structure preclude any refinancing or modification of any loan terms. This is why most Delaware Statutory Trust managers proceed with a management and divestment strategy which includes a sale for the benefit of the owners of DST interests within year 7 -8. It is possible for some Delaware Statutory Trusts to be sold in a shorter timeframe should an excellent offer arise due to equity growth of the properties in the portfolio. In this event, owners of DST interests can 1031 exchange out of the Delaware Statutory Trust into another DST or into any other like kind property.

DON'T FORGET TO REPLACE YOUR DEBT, EVEN WITH A DELAWARE STATUTORY TRUST INVESTMENT

In the event you want a totally tax deferred 1031 exchange transaction which includes a purchase of a Delaware Statutory Trust interest, you may need to have debt from the DST assigned to you for the benefit of your 1031 exchange. Your Registered Investment Advisor or Broker-Dealer should be willing to assist you as you determine the amount of debt necessary for your particular exchange scenario, and thereby arrange with the DST sponsor to assign such debt to you.

DISCLAIMER:

To ensure compliance with requirements imposed by the IRS, we inform you that the information posted within this guide does not contain anything that is intended as legal or tax advice, and that nothing herein can be relied upon as legal or tax advice. Further, the IRS wants us to let you know that nothing herein can be used for the purpose of (i) avoiding tax-related penalties under the Internal Revenue Code, or (ii) promoting, marketing, or recommending to another party any tax-related matter addressed herein. If assisting with your Section 1031 tax-deferred exchange, Fyntex cannot advise the owner concerning specific tax consequences or the or the advisability of a tax-deferred exchange for tax purposes. We recommend that anyone contemplating an exchange seek the advice of an accountant and/or attorney.