Tweed Financial Services

For further information, contact:
Robert R. Tweed: President
Tweed Financial Services, Inc.
(626) 588-1520
www.tweedfinancial.com

The 1031 Process

Many of you have heard the term a "1031 exchange", but what exactly is a 1031 exchange and how does it work? First of all the number 1031 comes from the IRS code book. It's defined as:

IRC Section 1031 (a)(1) states:
"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."

Sounds good, but the first question in my experience that always comes up is, what constitutes "like-kind property?" The truth is, it's pretty much any type of property that you can get a deed of trust on and is not your principle residence. If you sold an apartment, it doesn't mean you have to buy another one. We've been involved in sellers who sold an apartment building and ended up buying everything from raw land, to land leases, to single family rentals, NNN lease properties and even oil and gas leases in Texas. Really any form of investment real estate located in the United States will qualify.

The first step is to let your escrow agent know that you are going to be doing a 1031 exchange at the close of your escrow. The second step is to retain an "Accommodator" or "Qualified Intermediary" (different terms for the same thing). The Accommodator's job is to temporarily hold title to your funds so that you don't personally take possession of the money until your exchange has been completed. This is very similar process as an IRA roll over, where you have to keep your retirement assets with a 3rd party. Once you've taken any funds in your own name, they immediately become taxable, so the Accommodator holds the funds in their name for you, satisfying the IRS. After that you have 45 days to "identify" the property or properties that you wish to purchase. This means that you have to have a form filled out with the addresses of the properties that you want to buy time stamped and filed with the accommodator by midnight of the 45th day. By the way, this includes all days, even Sundays and holidays. After that you have another 135 days to actually close escrow on your purchases. This gives you a total of 180 days from your close of escrow to complete your exchange. If you go past that, the money is taxable.

When working with investors we've learned the hard way, that the 45 day period in which you have to identify your "upleg" (replacement properties) can be a mad scramble and very stressful. Most people we've worked with comment on how fast those 45 days seem to go. You don't want to wait until your escrow closes to start looking for your replacement property. We've found that the best time is just when you're going into escrow and have that extra window of time while your sale property ("downleg") is waiting to close. You need to have a clear plan ahead of time, otherwise you can be pulled in many different directions and get very confused. Suddenly you'll find a lot of people with many different opinions about what you should do. In our case generally we have an access to many different properties available for clients to choose from, or we have a clear picture of what our client wants so we can draw from our network of property sources across the US. This makes the 1031 process much more relaxed and easy for the investor to deal with.

In 90% of the cases we work with, the investor uses the "three property rule" when identifying. This means that you can choose up to three properties to list with your accommodator and you can close on any combination of them. This is fairly easy and straight forward. There are several other methods you can use, but they are not very common and much more complex. If you need to use them, the accommodator will gladly explain them. For a more detailed explanation log onto: http://www.exeter1031.com/pdfs/Section_1031_Tax_Deferred_Exchange_Reference_Manual.pdf For this article I want to keep it simple.

Two of the more important rules of which you need to be aware are that: you need to purchase replacement properties whose total value is equal to or greater than the value of the property you sold (or lose some of the benefits of the 1031 exchange); and you need to replace the debt from the property you sold with new debt that is also equal to or greater than the original debt.

For example, if you sold a $1,000,000 apartment building with $400,000 in debt, then whatever combination of properties that you exchange into must equal at least a total of $1,000,000 and they must have at least $400,000 of debt. You could buy one property that is $500,000 with $250,000 of debt and a second property for $700,000 with $350,000 in debt. This gives your replacement portfolio a total value of $1,200,000 with a total of $600,000 in debt, which would easily satisfy the above two rules and keep the IRS happy. As you can see, the total value and the replacement debt can be in any combination on the properties you're buying; it's the total of them that the IRS is looking at.

As well, we feel it's an important strategy to split up your equity and diversify into more than one replacement property. Most people we work with have had a substantial gain on their properties over the years, so why not take that gain and spread the risk around to different properties in different states as well as different types of properties. Again, before you go into this process you need to get yourself educated and have a plan, <u>*before*</u> trying to determine all this while in the 45-day period or your head will swim and keep you up at night. Please be sure and read our other articles and get yourself well acquainted with the process before you sell your property. Happy hunting!

As with any complex transaction, it's important to consult with your CPA and/or tax attorney to make sure you get precise advice for your particular case! For a personal, private consultation, please give me a call at (626) 588-1520.