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# 1031 Exchange



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## What is a 1031 Exchange?

The Internal Revenue Code provides that a taxpayer may sell an asset (personal property or real property) and defer payment of capital gains tax if that taxpayer uses the proceeds to acquire a like kind replacement asset.

## Why Exchange?

Capital gains tax is significant;  
Reinvestment into replacement property allows taxpayer to leverage dollars that would otherwise be spent on taxes;  
Allows for non-income producing property to be replaced with income producing property; and  
Allows taxpayer to diversify portfolio and minimize risk.

The fundamental advantages of a tax-deferred exchange may be utilized to diversify, consolidate or leverage your investment portfolio. With respect to real property, the broad definition of like-kind provides investors with numerous options to accomplish their investment goals.

### 3 Requirements to Defer Capital Gains Tax Under Section 1031

(1) The property disposed of and the property received must be held for productive use in a trade or business or for investment. Property held primarily for sale does not qualify. For example, stock in trade is excluded; this is property that would be properly included in inventory or property held for sale to customers in the ordinary course of the taxpayer's trade of business. Likewise, real property held for sale to customers in the ordinary course of a trade or business is commonly referred to as "dealer property."

(2) The property disposed of and the property received must be of "like-kind"—the "like kind" requirement is different for personal property than it is for real property. Like kind Real Property. Real property is like kind to other real property whether improved or unimproved and whether used for different purposes. Likewise, unproductive real estate held by one other than a dealer for future use or future realization of the increment in value is considered "held for investment" and not primarily for sale. Like Kind Personal Property. For personal property assets to qualify as like kind, the assets must be in either the same General Asset Class or the same Product Class. If there is no applicable General Asset Class and no applicable Product Class, the assets must be of the same nature or character to be considered like kind. (see page 8 for more information)

(3) There must be an "exchange" as distinguished from a "purchase and sale". There are 4 methods of Exchanging: Simultaneous Exchange, Delayed Exchange, Reverse Exchange and Construction/Improvement Exchange. (see page 5 for methods of exchanging)

#### Examples of Like Kind Real Property

- Commercial building for a ranch or farm
- A leasehold interest of 30 years or more for a fee interest
- Rental house for farmland
- Improved real property for unimproved real property
- Conservation easement in one farm for fee interest in another farm
- A utility easement for a utility easement
- Timber to be severed for a fee interest in land

#### Examples of Like Kind Personal Property

- Backhoe for a bulldozer (NAICS Product class 333120)
- Crane for a tractor (NAICS Product Class 33120)
- Grader for a snowplow (NAICS Product class 333120)
- A computer for a printer (asset class 00.12)
- Airplane for helicopter (asset class 00.21)
- A novel copyright for another novel copyright (same nature and character)



## 4 Ways to Exchange

1. **The Delayed Exchange** - The most commonly utilized tax planning strategy available to investors is the delayed exchange. A delayed exchange results when there is a delay between the sale of the relinquished property and the purchase of the replacement property. Also referred to as a "Starker Exchange" because of the landmark 1979 federal case entitled *Starker v. U.S.*, 602 F.2d 1341 (9th Cir. 1979), wherein the court substantiated the validity of the delayed exchange process. Prior to the *Starker* case, §1031 of the Internal Revenue Code authorized tax-free exchanges of real and personal property. Thereafter, Congress, in the 1984 Tax Reform Act, adopted subsection 1031(a)(3) which created the 45-day identification period and the 180-day exchange period. Finally, on April 25, 1991, the IRS promulgated the final regulations under section 1.1031(a)-1, et. seq. which provide specific rules for deferred like-kind exchanges. The delayed exchange provides investors up to 180 days to purchase replacement property after the relinquished property is sold. And, the use of a Qualified Intermediary is required to facilitate a valid delayed exchange. The delayed exchange occurs in three fundamental steps:

**STEP ONE:** Sale of the Relinquished

Property: Before closing on the sale of the relinquished property, the Exchanger retains a Qualified Intermediary (which will be referred to as the Q.I.). The Q.I. prepares an exchange agreement, an assignment of the sales contract and the closing instructions to the escrow/closing agent. The Q.I. instructs the escrow/closing agent to deed the relinquished property direct to the buyer and to deliver sale proceeds directly to The Q.I. —thereby preventing the Exchanger from having actual or constructive receipt of the funds. Once the funds are delivered to The Q.I., access to the funds is restricted for the remainder of the exchange period. In short, IRC §1031 provides strict rules pertaining to the release of funds to the Exchanger even where the Exchanger decides not to proceed with the exchange.

**STEP TWO:** Identification of the Replacement Property: The Exchanger must identify replacement property within 45 calendar days after the close of the relinquished property. The identification is proper only if the replacement property is designated as replacement property in a written document signed by the Exchanger and hand-delivered, mailed, telecopied, or otherwise sent to the person obligated to transfer the replacement property to the Exchanger

(i.e. the seller of the replacement property) or to any other person involved in the exchange (such as the Qualified Intermediary) other than the Exchanger or a disqualified person. Three identification rules apply, which limit the number of properties the Exchanger may identify:

**3-PROPERTY RULE:** Three properties no matter what the fair market value; or

**200-PERCENT RULE:** Any number of properties as long as the aggregate fair market value does not exceed 200% (2x) of the fair market value of all the relinquished properties; or

**95-PERCENT RULE:** Any number of properties without regard to value—provided 95% of the value of the identified properties is acquired.

**STEP THREE:** Purchase of Replacement Property: Within 180 calendar days from the sale of the relinquished property, or the Exchanger's tax filing date, whichever is earlier, the Exchanger must acquire like-kind replacement property and the property acquired must be one or all of the previously identified replacement properties. The Exchanger again assigns the purchase and sale contract to The Q.I., who purchases the replacement property with the exchange proceeds and causes the seller to deed the replacement property direct to the Exchanger.

## Delayed Exchange Timeline



# 4 Ways to Exchange Continued...



relinquished properties must be delivered to the EAT or to another party to the exchange. The exchange must be completed within 180 days (i.e. relinquished property must be conveyed to third-party buyer and replacement property must be conveyed to the Exchanger).

### 3. The Simultaneous Exchange

A simultaneous exchange occurs when the relinquished and replacement properties close at the same time. The use, however, of a Qualified Intermediary is still required and assures the Exchanger that he does not have constructive receipt of his funds, thus ensuring the preservation of safe harbor treatment under the Treasury Regulations.

### 4. The Improvement Exchange

The Improvement, Construction or Build-to-Suit Exchange occurs when the Exchanger uses exchange proceeds to improve (i.e. make capital improvements) new replacement property. The improvement exchange can occur in the context of a delayed or reverse exchange. In the context of a delayed exchange, the Exchanger first sells the relinquished property using a Qualified Intermediary ("QI"). Once the sale of the relinquished property is complete, the Exchanger has 45 days to identify the replacement property, including the improvements to be made. Thereafter, the Exchanger enters into a purchase and sale contract for the replacement property and enters into a

**2. The Reverse Exchange** A reverse exchange results when the replacement property is acquired prior to the sale of the relinquished property. The IRS formally acknowledged reverse exchanges effective September 15, 2000. (See, Rev. Proc. 2000-37). With the help of a Qualified Intermediary ("QI"), the Exchanger utilizes an Exchange Accommodation Titleholder ("EAT") to purchase either the relinquished property or the replacement property. As with delayed exchanges, the reverse exchange must be completed within 180 days.

#### TWO DIFFERENT PARKING METHODS FOR REVERSE EXCHANGES:

**(A) Exchange Last, aka Park Title to the Replacement Property.** In this parking arrangement, the EAT acquires title to the replacement property with funds loaned by the Exchanger. The EAT holds that property until the Exchanger finds a buyer for the relinquished property. After a buyer is found, the QI sells the relinquished property to the buyer and uses the exchange proceeds to purchase the replacement property from the EAT. The EAT uses the sale proceeds to repay its loan from the Exchanger. Thus, the exchange occurs at the end of the transaction.

**(B) Exchange First, aka Park Title to the Relinquished Property.** In this parking

arrangement, the QI sells the relinquished property to the EAT. The EAT purchases the relinquished property with funds loaned from the Exchanger. Concurrent therewith, the QI uses the proceeds to purchase the replacement property and causes the seller to convey title directly to the Exchanger. Thus, the exchange occurs at the beginning of the transaction. Thereafter, the EAT continues to hold title to the relinquished property until such time as the Exchanger finds a buyer. After a buyer is found, the EAT sells the relinquished property to the buyer and uses the proceeds to repay its loan from the Exchanger.

In either scenario, the EAT will enter into a management agreement and a lease with the Exchanger to allow the Exchanger management responsibilities over the property for the duration of the parking period. Additionally, the EAT will require hazard and liability insurance during the holding period. And, in a transaction involving financing, the EAT may become the borrower under a non-recourse loan. Upon the expiration of the exchange period or the sale of the relinquished property and transfer of the replacement property to the Exchanger, the Exchanger assumes the loan. Timeline: No later than five business days after the EAT acquires its ownership interest in the parked property, the EAT and the Exchanger must enter into a written qualified exchange accommodation agreement. If it is the replacement property that is parked, the Exchanger then has 45 days to identify one or more relinquished properties. Written identification of the

# 4 Ways to Exchange Continued...

written Qualified Exchange

Accommodation Agreement ("QEAA") with the QI's Exchange Accommodation Titleholder ("EAT"). The Exchanger then assigns the rights to the purchase and sale agreement to the EAT who uses the exchange proceeds to acquire title to the replacement property and complete the identified improvements. Upon completion of the improvements, or at the end of the 180th day, whichever is earlier, the EAT transfers title to the newly-improved replacement property to the Exchanger. If—in addition to the exchange proceeds—construction financing is required to complete the improvements, the EAT will become the borrower under a non-recourse loan. When the EAT transfers the property to the Exchanger, the Exchanger is substituted as the borrower and assumes the construction financing. The same time frames apply to the improvement exchange in that the replacement property and its improvements must be identified within 45 calendar days. The identification requirement is satisfied if a legal description is provided for the underlying land and as much detail is provided regarding construction of the improvements as is practical when the identification is made. It is critical that the Exchanger receive improvements/replacement property that are/is substantially the same as the improvements/replacement property identified. Likewise, the improvements must be completed and title conveyed by the EAT to the Exchanger within the earlier of 180 calendar days from the close of the relinquished property or the tax-filing date for the Exchanger. In the context of a reverse improvement exchange, the improvements must be completed and title conveyed from the EAT to the Exchanger within 180 calendar days from the date EAT acquired title. Only the improvements that are complete within the exchange period will qualify for the exchange.



## Reverse Exchange Timeline



# The Personal Property Exchange

A IRC §1031 tax deferred exchange allows taxpayers to defer capital gains taxes on the disposition of personal property assets such as aircraft, automobiles and trucks, and agricultural and construction equipment.

## Like Kind Requirement

To qualify as like kind, personal property assets must be in either the same General Asset Class, the same Product Class, or the same nature or character.

## 13 General Asset Classes:

The Treasury Regulations governing §1031 exchanges specify the following classes:

- Office furniture, fixtures and equipment
- Information systems (computers and peripheral equipment)
- Data handling equipment, except computers
- Airplanes, except those used commercially, and helicopters
- Automobiles and taxis
- Buses
- Light general purpose trucks
- Heavy general purpose trucks
- Railroad cars and locomotives, except those owned by railroad transportation companies
- Tractor units for use over-the-road
- Trailers and trailer mounted containers
- Vessels, barges, tugs and similar water-transportation equipment, except those used in marine construction
- Industrial steam and electric generation and/or distribution systems



## Product Classes

If assets do not fall within any of the 13 General Asset Classes, they may be like kind if they are within the same Product Class established by the North American Industrial

Code System ("NAICS"), the industry classification system used by statistical agencies of the United States. For NAICS codes, see [www.census.gov/eos/www/naics](http://www.census.gov/eos/www/naics).

## Same Nature and Character

If there is no applicable General Asset Class and no applicable Product Class, the assets must be of the same nature or character to be considered like kind.

## Non-Depreciable Assets

Non-depreciable tangible property such as art, coins and other valuable collectibles and non-depreciable intangible personal property such as copyrights and franchise

agreements are eligible for tax deferral when exchanged for like kind property—i.e. property of the same nature and character.

## Personal Property Ineligible for Tax

### Deferral

Under IRC §1031, any gain from the sale of the following types of property is not eligible for tax deferral:

- Stock in trade or other property held primarily for sale
- Stocks, bonds, or notes
- Other securities or evidence of indebtedness or interest
- Interest in a partnership
- Certificates of trust or beneficial interests
- Choses in action
- Goodwill or Going Concern

## Examples of Like Kind Personal Property

- Backhoe for a bulldozer (NAICS Product class 333120)
- Crane for a tractor (NAICS Product Class 33120)
- Grader for a snowplow (NAICS Product class 333120)
- Farm tractor for cotton baler (NAICS Product Class 333111)
- Harvesting machinery for haying machines NAICS Product Class 333111)
- Airplane for helicopter (asset class 00.21)
- A computer for a printer (asset class 00.12)

**Livestock special rule: Livestock must be of the same sex to be considered like kind.**

**Intangible personal property—special rule: The determination of whether intangible personal property is like kind to other intangible personal property depends on (i) the nature or character of the rights involved (e.g. a patent or a copyright) and (ii) the nature or character of the underlying property to which the intangible personal property relates (e.g. a novel or a song).**

# Do the math before you sell your Income or Investment Property

Taxes are paid on capital gain, not equity or profit. It is possible to sell property without realizing much profit and still owe substantial capital gains tax. Capital gain is simply the difference between the sales price and the adjusted basis (i.e. what you paid for the property, plus amounts spent on capital improvements, less depreciation taken) less any closing costs associated with the sale. To calculate your estimated capital gain: First subtract the

adjusted basis from the sales price; then subtract the costs of your transaction, commission, fees, transfer tax, etc.; finally, multiply the capital gain by your combined tax rates (Federal and State) to determine your estimated capital gain tax.

	Example
1. Calculate Net-Adjusted Basis:	
Original Purchase Price	\$400,000
Plus Capital Improvements	\$25,000
Minus Depreciation Taken	(\$175,000)
Equals Adjusted Basis	\$250,000
2. Calculate Capital Gain:	
Current Sales Price	\$600,000
Minus Exchange Expenses	(\$30,000)
Minus Adjusted Basis	(\$250,000)
Equals Capital Gain	\$320,000
3. Calculate Capital Gain Tax:	
Gain Attributable to Depreciation (\$175,000 x 25% = depreciation)	\$43,750
Plus Federal Capital Gain Tax (\$320,000 - \$175,000 = \$145,000 x 15%)	\$21,750
Plus State Capital Gain Tax (e.g. CA approx. 10% x \$320,000 [cap. gain])	\$32,000
= Combined Tax Due	\$97,500

The formula set forth above is provided to help you determine your approximate gain and the sums that you may wish to defer through your exchange transaction. Consult with your tax advisor to determine the correct values and whether an exchange is appropriate for your circumstances.

**100% Deferral**—to fully defer state and federal capital gain taxes, the Exchanger must reinvest all exchange proceeds and either acquire property with equal or greater debt or reinvest additional cash equal to the debt relief. The following worksheet is a useful tool for determining the amount of cash and debt that should go into the replacement property.

## RELINQUISHED PROPERTY Example

Sale Price: \$400,000  
 Minus Existing Loans: \$150,000  
 Minus Exchange Expenses: \$25,000  
 Equals Net Proceeds: \$225,000

## REPLACEMENT PROPERTY Example

Purchase Price: \$600,000  
 Minus New Loans: \$375,000  
 Equals Minimum Down: \$225,000

Your minimum down payment for the replacement property should be equal to or greater than the net proceeds from the sale of your relinquished property. Otherwise, you may have boot in the form of cash.

The taxpayer who disposes of the relinquished property must be the same taxpayer who acquires title to the replacement property. Problems arise when title to the relinquished property is held differently than title to the replacement property. For example, husband and wife dispose of property and acquire new property to which only husband is on title. Or, partnership ABC disposes of property and partner A individually acquires replacement property with title in A's individual name. Or, ABC Irrevocable Trust disposes of property and A acquires title to the replacement property individually.

### The following scenarios are disallowed

- Husband relinquishes and husband and wife acquire property of equal value.
- ABC Corporation relinquishes and XYZ Corporation acquires.
- ABC Partnership relinquishes and partners acquire as individuals.
- ABC Partnership relinquishes and XYZ Partnership acquires.
- Multi-member LLC relinquishes and members acquire as individuals.
- ABC multi-member LLC relinquishes and XYZ multi-member LLC acquires.

**Exceptions to the "same vesting" rule:** It is possible to have different entities disposing of the relinquished property and acquiring the replacement property if, in fact, the entities are "disregarded entities" wherein the actual taxpayer is the owner or member of the entity and that member/owner taxpayer is the same for both the relinquished property entity and the replacement property entity. A disregarded entity is a type of business entity or trust, which is disregarded for federal income tax purposes. In other words, the owner of member of the entity is treated as the taxpayer for federal income tax purposes. For example, revocable living trusts, which are used to avoid probate are disregarded entities as are Illinois Land Trusts, single member limited liability companies and Delaware Statutory Trusts.

### Examples of Scenarios which are allowed using different entities:

- Individual relinquishes and an LLC which individual is the sole member of completes the acquisition.
- Husband and wife as trustees of a revocable living trust, which is a true pass-through trust, relinquish, and husband and wife acquire as individuals.
- Single-member LLC relinquishes and sole member acquires as an individual.
- Individual relinquishes and individual's estate acquires due to the death of the individual.

### The Exchange Contract Addenda

When exchanging, insert this language into your purchase and sale contract or call your QI for a personalized exchange contract addendum:

#### PURCHASE AGREEMENT FOR THE SALE OF RELINQUISHED PROPERTY

Buyer acknowledges that it is the intention of Seller to effect an IRC §1031 tax-deferred exchange, which will neither delay the closing nor cause additional expense or liability to the Buyer. Buyer further acknowledges that Seller's rights and obligations under this agreement may be assigned to a Qualified Intermediary, to facilitate the exchange. Buyer agrees to cooperate with Seller and QI to enable Seller to complete the exchange.

#### PURCHASE AGREEMENT FOR THE ACQUISITION OF REPLACEMENT PROPERTY

Seller acknowledges that it is the intention of Buyer to complete an IRC §1031 tax-deferred exchange, which will neither delay the closing nor cause additional expense to Seller. Seller further acknowledges that Buyer's rights under this agreement may be assigned to a Qualified Intermediary, for the purpose of completing the exchange. Seller agrees to cooperate with Buyer and QI in a manner necessary to enable Buyer to complete the exchange.

# Q&A

## **What does the term 1031 refer to?**

1031 is the number assigned to the Internal Revenue Code Section that provides for the tax-deferred exchange of real and personal property.

## **What are “Safe Harbors”?**

This term refers to the rules established by the 1991 Treasury Regulations for tax-deferred exchanges which provide that—if followed—the IRS will allow the exchange to qualify.

## **What is a Qualified Intermediary?**

An individual or business entity that provides the following functions/services in a 1031 exchange: (1) acquires the relinquished property from the exchanger and causes it to be transferred to the buyer; (2) holds the exchange proceeds to avoid exchangers’ actual or constructive receipt of funds; and (3) acquires the replacement property and causes it to be transferred to the exchanger.

## **Why use a Qualified Intermediary?**

Use of a Qualified Intermediary is sanctioned as a safe harbor by the IRS.

## **What is Like-kind?**

Real property is like-kind to all other real property, except foreign real property, as long as it is held for investment or the productive use in a trade or business. Personal Property must be either the same General Asset Class or Product Class or same nature and character..

## **How do I properly identify my replacement property?**

Property is properly identified only if it is unambiguously described in a written document signed by you and hand-delivered, mailed, telecopied, or otherwise sent to the person obligated to transfer the replacement property to you or to any other person “involved in the exchange” (e.g. the Qualified Intermediary) other than you or a person disqualified under Treas. Reg. § 1.1031(k)-1(k). Real property generally is unambiguously described if it is described by a legal description, street address, or distinguishable name (e.g. the Mayfair Apartment Building). If at the end of the identification period—45 days—you have identified more properties than permitted by IRC § 1031, you are treated as if no replacement property was identified and your exchange will be disallowed.

## **What are the 45 and 180-day deadlines?**

Beginning with the close of the relinquished property, you have 45 days thereafter to identify the properties you intend to purchase and 180 days thereafter (or the due date for your tax return— whichever is earlier) to complete the acquisition of those properties. In addition, the 45-day identification period and the 180-day exchange period are calendar days. If the 45th day or 180th day falls on a weekend or holiday, the deadlines still apply. There are no extensions for Saturdays, Sundays, or legal holidays.

## **Is there any way to get an extension on the 45-day or 180-day deadlines?**

No extensions are allowed on the 45-day deadline. Your identification must be sent on or before midnight of the 45th day. With respect to the exchange period, it ends on the earlier of the 180th day or the due date (including extensions) of your tax return for the taxable year in which the transfer of the relinquished property occurs. Thus, if the exchange period is cut short by the earlier occurrence of your tax filing date, you may file for an extension in order to get the full 180-day exchange period.

## **What is Boot?**

Broadly defined, boot is anything given or received by the taxpayer that is not like kind or does not qualify under section 1031. Boot may be in the form of cash or a promissory note—i.e. cash boot or it may be in the form of debt—

i.e. mortgage boot. Any boot received by the taxpayer in connection with the disposition of the relinquished property that is not offset by boot given on the acquisition of the replacement property is gain that must be recognized—i.e. taxed. Alternatively, if the taxpayer receives boot but does not offset that boot with boot given on the replacement property, there will be a taxable consequence to the extent of the boot received and not offset. Thus, it is important to understand the boot netting rules.

## **Boot netting rules:**

1. Cash paid on the acquisition of the Replacement Property offsets cash received on the disposition of Relinquished Property;
2. Cash paid on the acquisition of Replacement Property offsets debt relief on the disposition of Relinquished Property;
3. Debt acquired/assumed on the Replacement Property offsets debt relief on the disposition of Relinquished Property.

**Caveat:** Debt assumed on the acquisition of Replacement Property will NOT offset cash received on the disposition of Relinquished Property.

## **If I own a property with another investor, can I exchange my interest if he doesn’t want to?**

Yes. You should clearly allocate each investor’s interest in the property before you sell. The investor who wishes to exchange may do so, and the other investor may receive cash (taxable). It is, however, very important that the investors be clear on their intentions before entering into an exchange agreement with a Qualified Intermediary.

## **What is a partial tax exchange?**

If the equity in your investment property is \$150,000 and you want to use only \$100,000 to purchase your replacement property and take \$50,000 out to buy a new car, you will have a partially tax-deferred exchange. The \$50,000 cash you took to purchase the car is considered taxable cash boot.

## **May I take out my basis and reinvest only the gain?**

No. Both basis and gain must be reinvested to defer taxes. The IRS does not allow you to allocate a portion of the money as basis and a portion as gain. Any money received by the Exchanger will be considered boot and taxed at a capital gain rate.

## **What is the exchange value of the property?**

Simply stated, the exchange value is your sales price less your closing costs. The Exchanger is responsible for reinvesting the exchange value (i.e. the cash and loan amount) when they purchase the replacement property. (See section on Boot.)

## **How is a seller carry-back note handled in an exchange?**

The note and deed of trust must be drawn in the Qualified Intermediary’s name. During the exchange period, the note must be converted to cash, which cash is then added to the exchange proceeds to be applied to the purchase of the replacement property in one of the following three ways:

1. Sell the note to a third party for cash that is then added to the exchange proceeds; or
2. Obtain the agreement of the replacement property seller to accept the note as part of the purchase price of the replacement property; or
3. Accept only a short-term note that will be paid in full prior to acquisition of the replacement property.

## **I own a piece of property that includes my primary residence and a rental unit. Would it still qualify for an exchange?**

Yes, so long as you remain consistent with your past tax returns. Consult with your tax advisor to determine the percentage value of the property you have attributed to investment. You may exchange that portion of the value. See Revenue Procedure 2005-14 for guidance.

## **Can I defer capital gains tax when I sell my primary residence?**

No. However, you can exclude up to \$250,000 of gain from taxation (or \$500,000 if you are married) under IRC § 121.

**Caveat:** If you originally acquired your residence as investment property, you must have owned it for a total of 5 years and you must have resided in it for at least 2 of the last 5 years in order to take advantage of the \$250,000/\$500,000 exclusion. And, the normal \$250,000 or \$500,000 amount will be reduced based upon the prorated amount of time the property was used for investment purposes.

***If I sell an investment property that I previously used as a principal residence, can I exclude gain under the §121 primary residence exclusion and defer investment gain under §1031?***

Yes. Revenue Procedure 2005-14 established the following rules for applying both sections:

1. § 121 applied before § 1031; and
2. Gain from depreciation may not be excluded under § 121, but can be deferred under § 1031; and
3. Boot will be taxed, but only to the extent it exceeds the § 121 limitation.

***Can I exchange with a related party?***

You can exchange with a related party subject to certain restrictions. If you buy your replacement property from a related party, or swap with a related party, the related party must also do an exchange and both of you must hold your replacement property for two years. If you sell to a related party, the related party must hold the property for two years and you must hold your replacement property for two years.

**Caveat:** If a related party transaction or series of transactions was designed to avoid the application of the related party rules, the exchange will be disallowed. Related parties include brothers and sisters (whole or half blood), spouses, children, parents and any other ancestors, any lineal descendants, and corporations or other business entities in which you own more than 50% either directly—or indirectly through your family members. Related parties also include certain fiduciary relationships described in IRC §267(b).

***Do I have access to my money during the exchange?***

No. The Treasury Regulations governing exchanges prohibits you from having actual or constructive receipt of the exchange funds during the exchange period. Only if you fail to identify replacement property in writing within the 45 day identification period, you may have your funds on the 46th day following your disposition. Otherwise, you must wait until you complete your exchange or until the expiration of the 180 day exchange period before you receive exchange funds. See Reg. 1.1031(k)-1(g)(6), commonly referred to as the “g6” restrictions or limitations.

**Exchange Expenses:**

Exchange expenses are certain costs incurred in connection with selling property that reduce the amount the taxpayer is required to reinvest because paying for these costs reduces the taxpayer’s gain. The use of proceeds to pay some closing costs, however, may result in boot. Revenue Ruling 72-456 provides that brokerage commissions reduce the taxpayer’s gain and increase the basis of the replacement property. Private Letter Ruling 8328011 implies that other transactional expenses should be allowed (i.e. reduce gain) if paid from the proceeds in connection with the exchange. These allowable expenses are referred to as “exchange expenses” on IRS Tax Form 8824, but are not specifically listed anywhere. Most tax practitioners consider the following exchange expenses to be allowable for purposes of reducing realized gain and recognized gain: real estate commissions, exchange fees, legal fees, title and escrow fees and transfer taxes.