

SECTION 1031

EXCHANGE HANDBOOK

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FEE SCHEDULE

All fees include phone consultations and calls and the services of an experienced lawyer overseeing your exchange. You earn the interest on your exchange balance while it is held in a segregated bank account during the exchange. Your exchange account is set up with a dual signature requirement to provide you with additional protection.

Forward Exchange Fees (Fee based on sale price of relinquished property)
(Price is for a two property (“leg”) exchange)

Up to \$500,000.00 sale price..... \$3,000.00
From \$500,000.00 to \$1 million sale price..... \$3,500.00
Above \$1 million sale price.....Contact us for quote

Additional Leg Fee (For each additional Leg)

More than one sale or replacement property leg: \$500.00 per leg

Reverse Exchange Fee Contact us for quote

A reverse exchange fee depends on the complexity. Please call for a quote.

Improvement Exchange Contact us for quote

Like reverse exchanges, improvement exchanges are more complex. Please call for a quote.

Contact us at:

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SELECTING AN EXCHANGE ACCOMMODATOR

Most states have no licensing requirements for exchange accommodators and few regulations on them. It is crucial to select an accommodator with professional credentials and extensive experience.

In the state of Washington, an exchange accommodator must comply with certain statutory requirements including written disclosures, errors and omissions insurance, and either a fidelity bond or the establishment of a qualified escrow or trust account.

Documentation

The exchange accommodator (the “Qualified Intermediary” (QI) in the 1991 safe harbor Treasury Regulations) prepares the documentation to qualify your transaction as a 1031 exchange. The documentation must be in place before the closing on the relinquished real property. The documents the QI provide include the exchange agreement, an assignment, and a notice of the assignment.

The exchange agreement is a contract between you the exchanger and the QI to complete the 1031 exchange under the safe harbor Treasury Regulations.

The assignment of the exchanger’s rights under the purchase and sale agreement to the QI substitutes the QI for the exchanger in transferring the relinquished real property to the buyer for 1031 purposes. You cannot receive the proceeds from the relinquished property. The exchange agreement and the assignment allow the QI to receive the proceeds as required by the Treasury Regulations.

The QI provides written notice to the other party to the transaction that the transaction is part of a 1031 exchange and that the exchanger has assigned to the QI the rights to transfer the real property.

Dual-Signature Accounts for Security of your Funds

We have set up protections for the safety of your funds with our banking partner, Umpqua Bank. Each client’s account is separate from any other client’s account. In addition, protections include: (1) dual signature requirement requiring your approval before any funds are wired, (2) On-line access to view your account balance and activity, (3) establishment of the account in a qualified escrow account with Umpqua Bank as escrow holder of the funds, (4) use of Umpqua Bank’s secure on-line portal to wire funds, with multi-party and multi-step verification process.

Member of FEA

We are members of the Federation of Exchange Accommodators (FEA), the national organization for QIs.

Knowledge and Professionalism

Jeffrey Paul Helsdon was the first Certified Exchange Specialist® in the south Puget Sound. He received his CES® designation in 2003. Mr. Helsdon has practiced law since 1987. He concentrates his practice in the areas of real estate and commercial transactions, partnerships, business formation, and estate and business-succession planning. Mr. Helsdon has been a QI since 1990. He holds an AV Preeminent rating from Martindale Hubbell and is licensed to practice before the U.S. Supreme Court, the Ninth Circuit Court of Appeals, the U.S. District Court for Western District of Washington, and all state courts in the state of Washington. Mr. Helsdon serves on the Government Affairs Committee of the FEA and the Association of Washington Business's Tax and Fiscal Policy Committee.

Questions to ask a prospective QI include:

How are the QI's fees structured?

Many QIs charge a front-end fee when you sell your old property and an additional fee when you buy your new property. Some also charge other fees. Make sure you understand the total cost of your exchange.

Who earns interest on the exchange funds?

In many cases, it is the QI. We do not. All our exchange clients earn the interest on the funds held during the exchange.

What is your experience and who will oversee my exchange?

Many QI companies experience frequent staff turnover—particularly the larger national companies that are often affiliates of title insurance companies. Mr. Helsdon has served as a QI since 1990. He has been a Certified Exchange Specialist® since 2003. Mr. Helsdon has been a member of the FEA for over 25 years. He personally oversees every exchange.

A TYPICAL EXCHANGE TIMELINE

Phase I: Sale of Relinquished Real Property

A. Contract Stage

1. Negotiate and sign your purchase and sale agreement (PSA) as seller.
2. Include language in your PSA to establish your intent to exchange. While no specific language is needed, it is helpful to put the other party on notice:

Seller intends to complete a 1031 Exchange and buyer agrees to cooperate with seller regarding the exchange at no additional cost or liability to buyer.

B. Closing Stage

1. Call us when you have a signed purchase and sale agreement. Information we will need:
 - Contact information for escrow
 - Your contact information
 - A copy of your PSA
 - If you wish to receive any cash directly from escrow at closing (this amount will be taxable to you).
2. We contact escrow and send exchange escrow instructions to them.
3. We prepare an exchange agreement, a qualified escrow agreement, and banking documents and obtain your signatures.
4. The transaction closes and funds wired into your exchange account.

Phase II: Written Identification of Possible Replacement Real Properties

1. You have 45 calendar days from the closing of the relinquished property to identify a list of possible replacement properties. You have the lesser of 180 days or the date your tax return is due for the year of the closing of the relinquished property (together with any extensions taken to file your return) to complete your exchange by purchasing one or more of those properties.
2. By this time, you should already be looking for replacement property.

3. You must provide us with a signed, written property identification before midnight of the 45th day from the closing of the relinquished property.

Phase III: Purchase of the Replacement Real Property

A. Contract Stage

1. Negotiate and sign your PSA as buyer of the replacement property.
2. Include language in your PSA to establish your intent to do a tax deferred exchange:

Buyer intends to complete a 1031 Exchange and seller agrees to cooperate with buyer regarding the exchange at no additional cost or liability to buyer.

C. Closing Stage

1. Call us when you have a signed purchase and sale agreement. Information we will need:
 - Contact information for escrow
 - A copy of your PSA
 - Whether you would like earnest money wired to escrow from your exchange account.
2. We initiate a wire to escrow of the funds necessary to close your purchase. You approve it. We send our 1031 escrow instructions to escrow.
3. We provide a final letter and a reconciliation between the exchange account and settlement statements.

1031 EXCHANGE HANDBOOK CAPITAL GAIN

CAPITAL GAIN

Gain is the excess of “amount realized” over the adjusted basis of the property disposed of or sold. Amount realized is roughly the sum of (1) money received, plus (2) the fair market value of property received, plus (3) the amount of the liabilities of which the taxpayer is relieved. Adjusted basis is essentially (1) the amount the taxpayer paid for the real property, (2) increased by items such as capital improvements, and (3) reduced by items such as depreciation.

Example:

On Jan. 1, Year 1, Bob purchased apartments for \$2,750,000 using \$750,000 cash and borrowing \$2,000,000. He takes \$100,000 in depreciation for each of Year 1 through Year 5. Bob had no capital improvements. On January 1, Year 6, when the principal balance of the loan is \$1,500,000, he sells the apartments for \$2,500,000 of cash, and the balance the buyer’s assumption of the \$1,500,000 loan.

The amount realized is the sum of money received (\$2,500,000) and the amount of the liability relief (\$1,500,000). The amount realized is therefore \$4,000,000. His adjusted basis is the amount he paid for the apartments (\$2,750,000) decreased by the depreciation for Year 1 through Year 5 (\$100,000 x 5 years = \$500,000). Thus, Bob’s adjusted basis is \$2,250,000 on January 1, Year 6. The excess of the amount realized over Bob’s adjusted basis is \$1,750,000. This is his gain.

TRANSACTION COSTS AND CLOSING COSTS

The example above assumed that closing and other selling costs have been factored into the amount realized and adjusted basis. The costs incurred to sell real property reduce the amount realized and the costs incurred to acquire property become part of the property’s basis.

BOOT AND GAIN RECOGNITION

Boot is money and non-like-kind property the exchanger receives as part of an exchange and liability relief that is not offset by liability assumed or cash paid by the exchanger as part of the exchange. An exchanger who receives boot in a transaction that otherwise qualifies for Section 1031 nonrecognition must recognize gain to the extent of the boot received.

LIABILITY RELIEF

Liability relief is treated as cash received. If the exchanger transfers real property subject to a liability, the liability of which the exchanger is relieved is treated as money received by the exchanger. IRC § 1031(d). Therefore, the liability relief would be boot. To defer all potential gain from the transaction, the exchanger will have to replace the liability relief. The liability-relief rule in Section 1031(d) provides that if another party to the transaction assumes the exchanger’s property, the exchanger will be treated as receiving money in the exchange. The use of sale

proceeds to pay off liability is also liability relief. If an exchanger either transfers cash or assumes liabilities to acquire replacement real property, the cash or liability assumed will offset the liability relief and reduce or eliminate the amount of boot the exchanger is deemed to receive.

Usually, the exchanger sells relinquished real property subject to a liability and the buyer pays cash for the full value of the real property with a portion applied to pay off the liability. The exchanger then borrows from a different lender to acquire the replacement real property. If the transaction is structured with a QI, the liability payoff on the closing of the relinquished real property will be treated as a liability assumed for purposes of the Section 1031(d) liability-relief rules, and the liability incurred to acquire the replacement real property offsets the amount treated as liability relief.

CASH NETTING

Cash paid by an exchanger in a transaction offsets the amount of liability from which the exchanger is relieved. Therefore, if the exchanger invests additional cash in the replacement real property, that amount will offset any liability from which the exchanger is relieved on the transaction.

CASH RECEIPT

Although cash paid offsets liability relief, liability assumed does not offset cash received.

DOES THIS SALE QUALIFY?

HOW TO DETERMINE WHETHER YOUR REAL ESTATE SALE COULD BE A 1031 EXCHANGE.

What did you do with the real property you are selling? If the real property has been held either for productive use in your trade or business or for investment, it may qualify for non-recognition of the gain realized from the disposition of the property under Section 1031.

INTERNAL REVENUE CODE § 1031 REQUIREMENTS

“No gain or loss shall be recognized on the exchange of real property held for productive use in a trade or business or for investment if such property is exchanged solely for real property of like-kind which is to be held either for productive use in a trade or business or for investment.” IRC § 1031(a)(1).

The requirements:

1. Real property
2. Held for qualified purpose.
3. Relinquished property of like-kind with replacement property.
4. An exchange.

1. Real property is defined in Treas. Reg. 1.1031(A)-3(A)(7), published Nov. 24, 2020:
 - a. Land and improvements to land. Improvements to land include:
 - i. “Inherently permanent structures (IPS); and
 - ii. “Structural components thereof.”
 - b. Unsevered crops and other natural products of land;
 - c. Various intangible interests.
 - i. Land development rights;
 - ii. Any “similar interests” if “the intangible asset derives its value from real property or an interest in real property and is inseparable from that real property or interest in real property.”
 - iii. Water rights: PLR 202309007.
2. “Held for” requirement:
 - a. Productive use in a trade or business or for investment.
 - b. Personal residence excluded.
 - i. If residence partially used for business, transaction must be bifurcated. Rev. Rul. 82-26, 1982-1 CB 115.
 - c. Purpose determined at time of exchange.
 - d. Taxpayer has burden of proof.
 - e. No specific holding period.
3. “Like-kind” requirement:
 - a. Real property not like-kind to personal property.
 - b. Whether property is real or personal controlled by federal, not state, law.
 - c. Like-kind refers to the nature or character of property and not quality or grade.
 - d. Leasehold of 30 or more years is like-kind to fee.
 - e. Unimproved for improved property.
 - f. Fractional interest for fee interest.
 - g. Easement for fee interest.
4. Same taxpayer requirement.
 - a. The same taxpayer disposing of relinquished property must acquire the replacement property.
 - b. A single member LLC that is a disregarded entity for federal tax purposes may be used to acquire the replacement property. Ltr. Rul. 9751012.
 - c. A husband and wife residing in a community property state who file a joint federal tax return are treated as a single taxpayer.

HOW DOES A 1031 EXCHANGE WORK?

The first requirement for a 1031 exchange is that the property must be real property. Both the real property to be disposed of and the replacement real property to be purchased must also be of like-kind. This is one of the most misunderstood concepts in 1031 exchanges. Like-kind relates to the nature and character of the properties, not to their quality or grade. Any real property held for productive use in a trade or business or for investment qualifies as like-kind to other real property to be held either for productive use in a trade or business or for investment. You can dispose of a rental duplex to buy a strip mall. You can dispose of a warehouse and buy a condominium that you intend to hold for investment. In addition, raw land held for investment qualifies for 1031 treatment even if not generating income.

Example 1:

Bill and Linda own and with a duplex on it they bought in 1986 and have rented it out ever since. They want to sell it and buy a condominium in Hawaii to rent out to others. Does this qualify as a 1031 exchange?

Yes, both properties are real property and held for income or investment purposes.

Example 2:

Bill owns land with an office building on it that he leases to doctors. Can he exchange the land and building for a piece of raw land on which to build an apartment building that he will hold for the rental income?

Yes, investment real property can always be exchanged for raw land held for income or investment purposes.

THE 45 DAY IDENTIFICATION RULE

Section 1031 requires the exchanger to identify a list of possible replacement properties within 45 calendar days of transferring the relinquished property. Extensions are not allowed except in the event of a federally-declared disaster. There are two ways to comply with the 45-day identification requirement. The first way is to have already purchased the replacement real property. If you use all exchange proceeds for that acquisition, the exchange is likely complete at that point.

If you haven't closed on a new property and spent all the exchange proceeds within 45 days after the relinquished property was transferred, you must identify a list of possible replacement properties. The list must be in writing. It must either show the property address, the legal description, or other means of specific identification. It must be signed by the taxpayer. This identification list must be presented to a person who is involved in the exchange before the deadline.

You can identify up to three potential replacement properties without regard to the value of the properties on the list. If you wish to identify more than three potential replacements, the total value of everything identified must be no more than 200% of the value of the property or properties relinquished. A third manner of identification exists, which is referred to as the 95% rule. In this rule, you can identify more than three potential replacement properties whose value is greater than 200% of the value of the relinquished properties but if you do, you must acquire properties on the list whose value is at least 95% of the value of all properties on the list. Few people attempt to qualify their transaction under the 95% rule.

If you wish to change the identification statement, you may do so until the expiration of the 45th day after the relinquished property has been transferred. After that date, it is not possible to change the identification. You must acquire at least one of the properties on the list.

Example 1:

Jane sells her old property for \$1,000,000 on January 1. She may identify up to three new properties of any value within 45 calendar days of January 1.

Example 2:

Jane sells her old property for \$1,000,000.00. Jane wants to identify four potential new properties; four condominiums selling for \$750,000 each. Is this okay? Answer, no, the four properties identified exceed two-hundred percent (200%) of the value of the property sold.

THE 180 DAY RULE

Section 1031 requires that you purchase one or more of the replacement real properties by the 180th day after closing of the relinquished property, or the date that your tax return falls due for the year of the relinquished property together with any extensions, whichever shall occur first. You must purchase one or more of the real properties listed on your 45-day identification list. You cannot buy real property not listed.

Example 1:

Brad identified only one property, a condominium under construction, within 45 days of his sale, but now the builder tells him it won't be completed and ready to close within the 180-day period. If Brad cannot close within 180 days his exchange will fail.

Example 2:

Katie closes her Relinquished Property on December 31. Her federal income tax return is due on April 15, which is 105 days after her Relinquished Property closed. Katie cannot close her Replacement Property until May 30. For Katie to close her Replacement Property, she must file an extension of the time to file her federal income tax return, in which case she has until October 15 to file her return. She therefore has her full 180 days to close her Replacement Property and can close it on May 30.

QUALIFIED INTERMEDIARY

The most commonly used safe harbor in Section 1031 exchanges is the use of a Qualified Intermediary (QI). The QI cannot be someone with whom you are related; either as a business relationship or family relationship. Thus, for example, your attorney, accountant or your brother are all disqualified. You must use someone with no fiduciary relationship with you for two years prior to the exchange to serve as QI. The QI prepares the exchange documents and holds the proceeds from the relinquished property closing during the exchange period. If you have actual or constructive receipt of the proceeds, the transaction will be a taxable sale. You must involve the QI prior to closing the sale of your current real property.

TITLE REQUIREMENTS

Section 1031 requires the taxpayer who owns the relinquished real property for federal tax purposes to acquire the replacement real property. If ABC partnership owns the relinquished property, ABC partnership must acquire the replacement property. If you and your spouse own the relinquished real property, you and your spouse must acquire the replacement real property. However, a husband and wife who are the sole members of an LLC holding qualifying property in a community property state, and who file their tax return jointly, are deemed to be a single member of the LLC. Since the LLC entity is disregarded for all purposes under the Internal Revenue Code when owned by a single member, a husband and wife in this situation may take title to the replacement property in the name of an LLC that they solely own.

Example 1:

Bill owns a rental building in his own name but wants to buy a new property to be held in the name of a new corporation that he wants to set up. Can he do this?

No, he must acquire the new property in his own name to complete this exchange.

Example 2:

George who is married to Jane owns a duplex that is titled in his name alone. Can he take title in the new property in his and Jane's name?

No, George must first complete his exchange in his own name. In the alternative, he may take an undivided interest in the property (i.e., Bill as to an undivided 50% interest to complete his exchange and Jane can take the other 50% interest. This will only work if Bill's purchase of the 50% interest will allow him to spend all his exchange proceeds and trade equal or up in value.

EQUAL OR GREATER INVESTMENT

To defer 100% of the gain from the relinquished real property you must buy qualifying replacement real property of equal or greater value. There are two aspects of the rule. First, you must buy qualifying replacement real property with equal to or greater equity than the relinquished real property, using the net proceeds from the relinquished real property to acquire it. Second, you must buy qualifying replacement real property with equal to or greater liabilities than the liabilities you are relieved of from the relinquished property closing, making up any difference by putting additional cash in the replacement real property closing.

Can you take money out of the deal at closing? Yes, this cash boot is taxable, but can be taken out of the exchange—only if paid by escrow directly to you at closing—without invalidating the rest of the exchange if the exchange documents so provide. You would simply pay tax on the boot taken. Once the QI receives proceeds of the relinquished property from escrow, you may no longer receive any portion of them.

Example 1:

Pete owns a property he is selling for \$200,000. He has a \$75,000 mortgage against the property. He wants to buy new property for \$125,000 with cash. Is this a fully tax deferred exchange?

No, Pete is buying down from \$200,000 to \$125,000. Pete owes tax on the amount for the buy-down (i.e., \$75,000).

Example 2:

As in the example previous, George decides to buy a property for \$250,000 by getting a loan for \$150,000 and using \$100,000 of the \$125,000 cash the QI is holding. Is this exchange fully tax deferred?

No, George did not use all the cash the QI was holding.

TIMING

The IRS requires that an exchange be completed before filing the tax return for the tax year in which it was begun. A taxpayer who begins an exchange after October 31 of Year A, intends to use her full 180 days to complete her exchange but has not acquired the replacement real property by April 15 of Year B, and has not filed her tax return for Year A by then, can file an extension of her tax return to have the full 180 days.

ADVANCED EXCHANGE TOPICS

Common Ownership Problems

Owners often misunderstand when a property they own with other people may be deemed to be a tax partnership by the IRS. They may hold title as tenants-in-common but be deemed a partnership for federal income tax purposes. A taxpayer may not exchange into or out of a partnership interest.

Another common ownership problem arises when an investment property is owned by an LLC taxed as a partnership. Some of the partners may wish to exchange while others wish to take the cash. They cannot exchange their partnership interest under Section 1031. They may be tempted to dissolve the LLC before closing. This may not be effective if the entity is dissolved immediately before the exchange. If you are contemplating a partnership split or your tax partnership is planning to sell investment real estate with partners wanting to take different tax positions, please call well in advance for adequate planning and consultation.

Refinancing the 1031 Property

There is a risk to refinancing the relinquished real property before closing. By contrast, there should be no issue with refinancing after the acquisition of the replacement property if it is done correctly.

Reverse Exchanges

What if you must acquire the replacement real property before closing the relinquished real property? If you do, the transaction will not qualify as a 1031 exchange. To qualify this structure requires a reverse exchange. In September, 2000, the IRS issued a safe harbor revenue procedure to accomplish either a reverse exchange or an improvement exchange. The safe harbor requires setting up a parking arrangement in which either the relinquished or the replacement property is parked with an Exchange Accommodation Titleholder. There are strict requirements in place, and the parking arrangement can be difficult to achieve. We have successfully accomplished many parking arrangements for our clients who have required them.

Improvement Exchanges

An improvement exchange allows you to buy land with part of the exchange proceeds and use the rest of the proceeds to make improvements to it. Like reverse exchanges, the Exchange Accommodation Titleholder will have the real property parked with it while the improvements are completed.

Vacation Homes

The IRS provided a safe harbor for exchanges of vacation homes in Revenue Procedure 2008-16. The exchanger must meet several requirements for the relinquished property to meet the qualifying use standard. First, the exchanger must have owned the relinquished real property for the 24 months immediately preceding the exchange. Second, for each of the two 12-month periods immediately preceding the exchange, the exchanger must have rented the relinquished property at fair rental to another person for at least 14 days. Third, the exchanger's personal use of the property during either 12-month period must be equal to or less than the greater of 14 days or 10 percent of the number of days the exchanger rented the property at fair rental.

The exchanger must meet several requirements for the replacement property to meet the qualifying use standard. First, the exchanger must own the replacement property for the 24 months immediately following the exchange. Second, the exchanger must rent the replacement property to another person for at least 14 days during each of the two twelve-month periods immediately following the exchange. Third, the exchanger's personal use of the replacement property during either 12-month period can not exceed the greater of 14 days or 10 percent of the number of days the exchanger rents the property at fair rental.

1031 EXCHANGES INVOLVING RELATED PARTIES

If an exchanger exchanges property with a related person and defers the recognition of gain under Section 1031, no gain is recognized if both the exchanger and the related party hold their acquired property for at least two years.

Rev. Rul. 2002-83: Exchanger may not transfer relinquished property to an unrelated party and acquire replacement property from a related party if the related party has a high basis in the replacement property and receives cash or non-like kind property, pursuant to Section 1031(f).

Section 1031(f) is designed to prevent taxpayers from using Section 1031 to shift tax basis between properties owned by related parties.

If the exchanger transfers the relinquished property to an unrelated party and acquires the replacement property from a related party, the two-year holding period is immediately violated.

Any person bearing a relationship to the taxpayer described in IRC § 267(b) or § 707(g)(1) is a related party, including:

- a. Members of a family (which include brothers and sisters, spouse, ancestors, and lineal descendants).
- b. Two corporations, which are members of the same controlled group.
- c. An individual in a corporation more than 50 % in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual (attribution rules apply).
- d. A corporation and a partnership if the same persons own more than 50% of the outstanding stock of the corporation and more than 50 percent of the capital interests or the profits interest in the partnership (attribution rules apply).
- e. A grantor or fiduciary of any trust.
- f. A partnership and a person owning, directly or indirectly, more than 50 percent of the capital or profits interest in such partnership (attribution rules apply).
- g. Two partnerships in which the same persons own, directly or indirectly, more than 50% of the capital or profits interest (attribution rates apply).
- h. Executor and beneficiaries of an estate.

Final Remark

There are literally thousands of variations on the scenarios mentioned in this writing. We are happy to consult with you at any time without charge and answer your questions about any aspect of 1031 exchanges.

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