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SECTION 1031 FORWARD AND REVERSE EXCHANGES

Section 1031 Exchanges of Investment or Trade or Business Property

1. **The sale of a Relinquished Property allows the taxpayer to exchange into a Replacement Property. Both properties must be held for investment or used in the trade or business by the taxpayer.**

2. **The taxpayer selling a property must be the same taxpayer buying the property.**

3. **Partnerships and limited liability companies would be the taxpayer. Partners or Members of the LLC are owners of a "security" and are not a TIC interest in a piece of real estate so they must stay together on an exchange. A Replacement Property may be 100% owned or owned as a fractional interest (TIC – Tenant in Common) in the property.**

4. **There are four basic requirements for a successful Section 1031 Exchange:**

   a) **Like Kind means investment or trade or business real estate for investment or trade or business real estate.**

   b) **Meeting the 45 day written identification period and the 180 day closing for the Replacement Property following the closing date of the Relinquished Property.**

   c) **One must purchase a Replacement Property that is equal to or greater in value than the Net Sales Price of the Relinquished Property. In addition, all of the Net Proceeds after payment of the principal balance of the mortgage must be reinvested as the down payment into the Replacement Property.**

   d) **The use of a professional Qualified Intermediary is used to control the documentation and procedures for the exchange to assure compliance with the internal Revenue Code.**

Standard Delayed 1031 Exchanges and Reverse 1031 Exchanges

Timing is everything in the exchange world and meeting the 45 day ID requirement and the 180 day closing requirement in tight buyer or seller controlled market conditions can be extremely difficult. In September of 2000 the IRS issued Revenue Procedure 2000-37 and created the Safe Harbor Reverse Exchange.

Here is how the reverse exchange works:

1. **The QI must follow all of the rules set out in Revenue Procedure 2000-37 to qualify the transaction for the safe harbor treatment.**

2. **A separate corporate or LLC entity is formed to hold the property to be acquired for the benefit of the exchanger. This is called an Exchange Accommodation Titleholder ("EAT") and is owned by the QI during the parking period.**

3. **The EAT purchases the parked property and holds it pursuant to the terms of a Qualified Exchange Accommodation Agreement ("QEAA"). The maximum holding period is 180 days. The exchanger provides a written identification of the property(s) that they plan to sell within 45 days of the date the EAT purchases the parked property.**

4. **Financing for the purchase must be arranged so that the EAT is the borrower and the exchanger is the guarantor of any loans:**

    a) **Combination of Bank 1st loan for the long term financing to be assumed by the exchanger upon completion.**

    b) **2nd Bridge loan from the same bank.**

    c) **3rd loan from exchanger or friends or family or temporary seller carry back.**

5. **The completion of the exchange is no different than that of a standard delayed exchange. The EAT becomes a normal seller to the exchanger.**

Benefits of a Reverse Exchange for the exchanger:

1. **Improved negotiation position of the exchanger for both the purchase of the Replacement Property and the sale of the Relinquished Property.**

2. **More control over the entire exchange process.**

3. **Less risk of failing the exchange and paying taxes.**

4. **Opportunity to purchase the "right" property instead of a "dumb" property just to save on taxes.**

5. **Better terms and economic results from both the purchase of Replacement Property and the sale of the Relinquished Property.**

STRATEGIES FOR INTEGRATING SECTION 1031 EXCHANGES WITH PERSONAL RESIDENCES AND SECOND HOMES

Section 121 – Sales of a Personal Residence

1. **Must have lived in the personal residence for 2 out of the last five years for the full exemption. The exemption amount would be reduced by IRS formula if owned and lived in for less than 2 years.**

2. **Each owner/resident is entitled to a $250,000 capital gain exemption (total forgiveness) this means $500,000 for a married couple or two co-owners in a common law or tenant in common relationship.**

3. **One can use this Section 121 exemption every 2 years, or 2 years after the last time the exemption was used.**

Examples of the Interface Between Section 1031 and Section 121

1. **Sale of Personal Residence**

   a) **Gain on sale exceeds the Section 121 Exemption of $250,000 per person or $500,000 per couple.**

   b) **Calculate the capital gain in excess of the Section 121 exemption and estimate your state and Federal tax liability at around 30%. Do you have any capital loss carryovers or poorly performing stocks or other investments that you can sell to offset that gain?**

   c) **If you have a large gain, consider moving out and renting your property and convert it to a Section 1031 investment property for the next two years. Sell the property in the 3rd year following your conversion to a rental property. Move in to a rental property, or if you have a low or no mortgage, consider refinancing your property to provide a down payment for a new personal residence. Keep the mortgage balance below your Section 121 exemption. The rental income should be sufficient to cover the debt service.**

   d) **If you sell the property at the end of the two year period, you can use a Section 1031 Exchange for part of property and still use the Section 121 exemption so long as you lived in the property for two of the last five years. You can use the personal residence exemption as a credit to "pay off" the debt on the property if you borrowed money to purchase another personal residence.**

2. **Home Office Considerations**

   a) **If you have been depreciating part of your personal residence as a home office, you will have to recapture the depreciation upon sale. The Section 121 Exemption does not count against depreciation recapture.**

   b) **If you do decide to sell your personal residence, you could use the percentage of the property allocated to your home office and do a Section 1031 exchange into a new property or into a new home office in your new personal residence to avoid recognizing the gain on the sale of the home office.**

3. **Sale of an Investment Property to Purchase a Personal Residence**

   a) **Purchase a multi unit property with an owners unit and allocate your Section 1031 exchange to the rental units attached.**

   b) **Purchase a farm or a vineyard property with a personal residence on it and allocate part of the property used for investment or in a trade or business to the 1031 exchange.**

   c) **Buy a rental property with your 1031 exchange proceeds. Rent it out for 2 years and then convert it to a personal residence. Make sure to own the property for at least five years after you purchase it through a 1031 exchange.**

4. **Helping Your Kids or Grandkids Buy a Personal Residence Using a Section 280 (a) Equity Sharing transaction.**

   a) **If you are selling an investment property you can use the proceeds or part of the proceeds to enter into a Shared Equity Financing Arrangement under Section 280 (a) and treat it as a Section 1031 exchange.**

   b) **You can purchase part of the property and rent your share to your kids using fair market rent. They would treat the rest of the property as a personal residence. This allows them to get home interest and property tax deductions and to build equity into the property over time. They can then inherit your share of the property as part of your estate plan with a step up in basis for your share to FMV on the date of death.**

c) **You must contact your tax attorney to make up a Shared Equity Financing Agreement that conforms to the Internal Revenue Code.**

Second Homes and 1031 Exchanges

1. **You cannot trade an investment property for a personal use property such as a second home, vacation home, personal residence or a property used by a family member not paying fair market rent to use the property.**

2. **You may purchase a vacation rental property and make some personal use of it in accordance with the vacation rental rules which typically allow a 14 day personal use period. Check with your CPA about any exceptions to the 14 day personal use rules that apply to your situation.**

3. **If you purchase a rental unit or a valid vacation home with your 1031 exchange and rent it for two years or more, you could then make it a second home or a personal residence. Sometimes this is a way to purchase a future retirement home with a 1031 exchange.**

RESCUING A FAILED 1031 EXCHANGE WITH A MONETIZED INSTALLMENT SALE

Concepts:

1. **What is a Section 453 installment sale? It is any sale in which the seller carries back an installment note from the buyer. This is known as seller financing.**

2. **What is an exchange that is intended to be tax-deferred under Section 1031, but that instead fails? It is a sale.**

3. **Who is treated as the buyer of relinquished property, in an exchange that fails? That would be the Qualified intermediary acting as the accommodator.**

4. **What is an exchange that fails and therefore becomes a sale, if the sale proceeds are not paid to the seller (the former exchanger) within the year of sale? It is an installment sale.**

5. **When an exchange fails, does the law require that the exchange accommodator disburse the sale proceeds to the seller in the year of sale? Not unless the exchange agreement which they signed requires the accommodator to do so**

Mechanism of Rescuing a Failing 1031 Exchange

1. **Before the end of the exchange period (or before the end of the identification period, if no identification of replacement property is made), and with the consent of the would-be exchanger, the 1031 accommodator/buyer assigns its position in the exchange agreement to a Dealer specializing as an installment sale intermediary, which becomes the successor accommodator/buyer;**

2. **The would-be exchanger and the Dealer then amend the exchange agreement to provide for a Monetized Installment Sale (M453SM), instead of lump-sum payment of the sale proceeds to the seller/would-be exchanger; and**

3. **The third-party lender's monetization loan to the would-be exchanger/now seller, can be funded when the Dealer. becomes the successor of the 1031 accommodator and converts the exchange agreement to a Monetized Installment Sale (M453SM) transaction.**

4. **Section 453(b)(1), Internal Revenue Code.**

   a) **"If the taxpayer actually or constructively receives money or property which does not meet the requirements of section 1031(a) in the full amount of the consideration for the relinquished property, the transaction will constitute a sale, and not a deferred exchange, even though the taxpayer may ultimately receive like-kind replacement property." Treasury Regulations Section 1.1031(k)-1(a).**

   b) **"Example: (i) M is a corporation that files its Federal income tax return on a calendar year basis. M and C enter into an agreement for an exchange of property that requires M to transfer property X to C. Under the agreement, M is to identify like-kind replacement property which C is required to purchase and to transfer to M. M transfers property X to C on November 16, 1992." Treasury Regulations Section 1.1031(k)-1(b)(3).**

   c) **Treasury Regulations Section 1.1031(k)-1(j)(2)(vi), Examples 3 and 5.**

   d) **"(iii) If B's right to demand payment of the $100,000 were subject to a substantial limitation or restriction (e.g., the agreement provided that B had no right to demand payment before November 14, 1991 (the end of the exchange period)), then, for purposes of this section, B would not be in actual or constructive receipt of the money unless (or until) the limitation or restriction lapsed, expired, or was waived." Treasury Regulations Section 1.1031(k)-1(f).**

** Disclaimer**

The Dealer is acting as a principal only and does not act in the capacity of a broker, sales representative, investment adviser, or tax or legal adviser; does not sell or recommend any security;

and does not accept any transaction fee or payment for transaction services. Circumstances may affect tax and legal outcomes. Each transaction is different and unique to each participant. Neither the Dealer nor any of its officers or employees may or does provide tax, legal or investment advice. Nothing herein is intended to be, or may be taken to be, tax, legal or investment advice. Interested parties should consult their legal, tax and investment advisers before participating in any transaction.

THE FOUR BASIC RULES FOR EXCHANGES

1. THE LIKE KIND PROPERTY RULE

All real estate held for investment or used in the trade or business is LIKE KIND. The type of property is immaterial, only the way that the Exchanger uses it counts.

2. THE FINANCIAL STRUCTURE RULE

The Replacement Property should have a Total Purchase Cost Equal to or Greater Than the Net Sales Price of the Relinquished Property;

AND

All of the Exchangers Equity in the Relinquished Property must be used to make the down payment of the Replacement Property.

3. THE 45 DAY IDENTIFICATION and 180 DAY CLOSING RULE

The Exchanger must IDENTIFY in WRITING to an independent third party, typically the Qualified Intermediary, who will acknowledge the receipt of the written identification made to the Exchanger no later than 45 days following the close of escrow (legal transfer of ownership) of the Relinquished Property.

a. **Identify up to a total of three properties regardless of value and purchase one or more of them.**

b. **Use the 200% of Gross Sales Price of the relinquished property rule as a limit while identifying more than 3 properties whose total combine Gross Purchase Prices are less than the 200% limitation and purchase one or more of them.**

AND

The Exchanger must CLOSE ESCROW on the Replacement Property no later than 180 days following the close of escrow of the Relinquished Property.

4. DOCUMENTATION AND PROCEDURES

All documentation and procedures contained in the Internal Revenue Code and the Regulations for a Section 1031 Exchange must be followed. This is typically handled by the Qualified Intermediary together with the escrow company or settlement attorney.

THE FINANCIAL STRUCTURE RULE

PHASE I TRANSACTION:

GROSS SALES PRICE

LESS: SALES COSTS

Commissions
Documentary Transfer Taxes
Certain Repair costs and repair credits
Escrow Fees
Exchange Fee
Attorney Fees

NET SALES PRICE

MORTGAGE	**REALIZED GAIN**
EQUITY or EXCHANGECREDIT	**ADJUSTED COST BASIS**

Balance Sheet Perspective **Profit & Loss Perspective**

PHASE II TRANSACTION

GROSS PURCHASE PRICE

ADD: PURCHASE COSTS

Attorney Fees
Escrow Fees
Title Insurance
Repair Costs

TOTAL PURCHASE COST

CAPITAL GAIN AND ADJUSTED COST BASIS

GROSS SALES PRICE

Less: Sales Costs

Commissions
Documentary Transfer Taxes
Certain Repair costs and repair credits
Escrow Fees
Exchange Fees
Attorney Fees

_____

NET SALES PRICE

Less: ADJUSTED COST BASIS:

Gross Purchase Price
+ Purchase Costs
+ Capital Improvements Made After Purchase

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= Cost Of Property

- (Accumulated Depreciation)

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= ADJUSTED COST BASIS

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= REALIZED GAIN

Consists of Capital Gain from Appreciation and Recapture of Accumulated Depreciation

Your effective tax rate on Long Term Capital Gain and Depreciation Recapture will normally range from 27% to 40% for Federal and State taxes depending upon the amount of your realized gain and your tax bracket.

DELAWARE STATUTORY TRUSTS

When it comes to investing in real estate, there are a lot of vehicles to choose from. Delaware Statutory Trusts (DSTs) have become very popular for experienced and inexperienced investors alike. Here is a simple list of the things you should do when investing into a DST.

When investing in a DST you should:

1. Perform thorough due diligence to evaluate the DST offering prior to investing.

Before investing in any program, it is important to read the Private Placement Memorandum (PPM) to know the objectives, identify the sponsor, understand the cash flow expectations, and inspect the fine details to verify that the program meets your investment goals. At 1031 Crowdfunding, our DST specialists are always happy to answer any questions you may have during your due diligence process.

2. Use a DST as a 1031 exchange backup plan.

If you are expecting to defer capital gains taxes on prior real estate investment endeavors by completing a 1031 exchange, we recommend you select a DST property as one of your three identified candidate replacement properties. In the common event that your other two candidate properties cannot be acquired within your exchange period, the DST property can be used as a backup to ensure your exchange can be completed.

3. Ensure the debt ratio adheres to your debt requirements if using the DST property as your replacement property in a 1031 exchange.

If you are attempting to complete a 1031 exchange with your DST investment, you know you need to adhere to the debt replacement principle. As a pass-through entity, DSTs pass the debt to the investors. Therefore, an investor acquires not only the value of the cash they invest but also the value of the debt they receive. With DST debt ratios typically ranging from 45% to 60%, an investor will receive shares valued at 45-60% more than the cash they invest without having to qualify with the banks to receive the debt. Furthermore, not all DSTs use debt, it is important to make sure candidate DSTs will pass on the correct amount of debt for your situation.

4. Diversify your portfolio with multiple DSTs or a multiple property DST.

DST's minimum investment amounts can be relatively low, allowing the investor an option to split their investment among multiple DSTs and diversify their real estate portfolio with multiple property types located in different locations. It is also becoming more common for individual DSTs to own a diversified

portfolio of properties. A multiple property DST offering is another way to diversify your personal portfolio.

5. Complete a 1031 exchange once the DST has come full cycle.

Having a beneficial interest in a DST that owns real estate assets is considered a "direct interest in real estate" and, thus, qualifies as a tax-deferrable real estate investment. At the completion of a DST investment, beneficial owners can leverage their income for greater future returns by engaging in a 1031 exchange by purchasing beneficial interests in another DST or another eligible real estate investment.

While the information provided above has been researched and is thought to be reasonable and accurate, it's important to understand that all investments, including real estate, are speculative in nature and involve substantial risk of loss. Additionally, private placements of securities are not publicly traded, are subject to holding period requirements, and are intended only for accredited investors who do not require a liquid investment.

1031 Strategies & Services Group

RALPH B. BUNJE, JR., CES, CPA (Inactive), MBA (Tax), MS (Accounting)

Ralph has over 40 years of practical consulting experience in financial management, accounting, income tax, investments, real estate and organizational and personal counseling. As a co-founder and partner of Bunje Lloyd & Company, a financial and real estate consulting practice in San Francisco, he has successfully managed merger, acquisition, reorganization, financing, joint venture, bankruptcy and problem asset engagements for clients. He is a trained mediator and has managed the mediation and dispute resolution elements of the practice.

He is a co-founder and the Chairman of Independent Exchange Services, Inc. (www.ies1031.com) a Qualified Intermediary for Section 1031 tax deferred exchanges since January 1980.

In January 2001, he became a co-founder and the President of Reverse Exchange Services, Inc. (www.reverse1031.com) together with Cecily Drucker, JD, and Max Hansen, JD, organized to provide a nationwide service for fellow exchange accommodators, CPA's, attorneys and other real estate professionals to structure solutions to both safe harbor and non-safe harbor Reverse Section 1031 Exchanges.

Ralph is currently a Past President and has been an Officer and Director of the Federation of Exchange Accommodators from 1991 to 2011. He has served as the Chairman of the Federation's Ethics Committee from 2007 to 2012, and teaches in the national training program. He has served on the Board of Directors of several different public and private companies.

Ralph has served as an expert witness in a number of cases involving 1031 exchanges.

Prior to co-founding Bunje Lloyd & Co in 1978, Ralph spent six years as a CPA with Touche Ross & Company, in San Francisco, CA providing accounting, audit, income tax and management consulting services to small and medium sized companies. Ralph was also associated with Dean Witter & Co., Inc. and Bache & Co., Inc. as an investment advisor and account executive for six years.

Ralph is a 1963 graduate of UCLA with a BSBA in Marketing and Accounting, a 1974 Graduate of Golden Gate University with an MBA in Taxation followed by an MS in Accounting in 1976. He is a retired Commander USNR.

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