Land Title Exchange Corporation

1031 EXCHANGE

Section 1031
Tax Deferred Exchanges

A Guide to the Best Strategy for Real Estate Investment

5 Reasons to Choose Land Title Exchange Corporation for Your Next Tax-Deferred Exchange:

1. ***Land Title Exchange Corporation*** *holds a $10 million fidelity bond. We also carry $4 million in errors and omissions coverage. Both amounts are in excess of what is required under the Colorado Consumers Protections Law.*
2. ***Land Title Exchange Corporation*** *is a member of the Federation of Exchange Accommodators (www.1031.org).*
3. ***Land Title Exchange Corporation*** *assures safety of funds by holding each taxpayers exchange proceeds in segregated accounts. We do not pool or commingle your exchange funds. We require dual authority to release your exchange proceeds and all interest earned on the account accrues to your benefit.*
4. ***Land Title Exchange Corporation*** *has handled over 8,500 exchanges. We specialize in superior customer service with knowledge in closing, title and exchange matters.*
5. ***Land Title Exchange Corporation*** *shares the same core values of Land Title Guarantee Company who has been in business in Colorado since 1967.*

SECTION 1031

TAX DEFERRED EXCHANGES IN A NUTSHELL

A Guide To
The Best Tax Strategy For Real Estate Investment

By Mary B. Foster & Jeremiah M. Long

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Tax deferred exchanging is an investment strategy that should be considered by anyone who owns investment real estate. Anyone involved with advising or counseling real estate investors, including real estate agents, lawyers, accountants, financial planners, enrolled agents, tax advisors, escrow and closing agents, and lenders, should know about tax deferred exchanging.

WHAT IS A TAX DEFERRED EXCHANGE?

A tax deferred exchange is simply a method by which a property owner trades one property for another without having to pay any federal income taxes on the transaction. In an ordinary sale transaction, the property owner is taxed on any gain realized by the sale of the property. But in an exchange, the tax on the transaction is deferred until some time in the future, usually when the newly acquired property is sold.

These exchanges are sometimes called "tax free exchanges," because the exchange transaction itself is not taxed.

Tax deferred exchanges are authorized by Section 1031 of the Internal Revenue Code. The requirements of Section 1031 and other sections must be carefully met, but when an exchange is done properly, the tax on the transaction may be deferred.

In an exchange, a property owner simply disposes of one property and acquires another property. The transaction must be structured in such a way that it is in fact an exchange of one property for another, rather than the taxable sale of one property and the purchase of another.

Today, a sale and a reinvestment in a replacement property are converted into an exchange by means of an exchange agreement and the services of a qualified intermediary – a fourth party who helps to ensure that the exchange is structured properly.

The IRS's regulations make exchanging easy, inexpensive, and safe.

MISCONCEPTIONS ABOUT EXCHANGING

People often fail to consider tax deferred exchanging as an investment strategy because they are misinformed about the requirements of exchanging. However, once their misconceptions have been cleared up, property owners usually find that Section 1031 is worth considering.

Here are a few common misconceptions about Section 1031 exchanges:

Myth: Exchanges require two parties who want each other's properties.

Fact: Two-party exchanges are possible, but in reality, such two-party swaps rarely occur. Today, an exchange is accomplished with the help of a qualified intermediary and usually involves four principal parties: the exchangor (the taxpayer), a buyer for the relinquished property, a seller of the replacement property, and the intermediary. The parties often do not know each other, and their properties may even be located in different states.

Myth: The like-kind requirement limits an exchangor's options.

Fact: Property must be exchanged for "like-kind" property. But "like-kind" simply means that real property must be exchanged for real property. All real property is like-kind, so a whole interest may be exchanged for a tenancy-in-common interest; one property may be exchanged for more than one property; a duplex may be exchanged for a four-plex; a single family residence may be exchanged for a motel; vacant land may be exchanged for an office building, etc. However, real property may not be exchanged for personal property. Personal property may be exchanged for other like-kind personal property.

Myth: In an exchange, title on the exchanged properties must pass simultaneously.

Fact: The properties do not have to close at the same time. However, in a deferred exchange, the replacement property must close within 180 days after closing on the relinquished property. In a reverse exchange, the replacement property is acquired first and the relinquished property must close within 180 days thereafter.

ADVANTAGES AND DISADVANTAGES OF EXCHANGING

The primary advantage of a tax deferred exchange is that the taxpayer may dispose of property without incurring any immediate tax liability. This allows the taxpayer to keep the "earning power" of the deferred tax dollars working for him or her in another investment. In effect, this money can be considered an "interest free loan" from the IRS. And this "loan" can be increased through subsequent exchanges. Moreover, under current law, this tax liability is forgiven upon the death of the taxpayer, which means that the taxpayer's estate never has to repay the "loan." The heirs get a stepped up basis on such inherited property; that is, their basis is the fair market value of the inherited property at the time of the taxpayer's death.

The taxpayer should also consider the disadvantages of a tax deferred exchange. These include the following:

(1) There will be a reduced basis in the replacement property, resulting from the carry-over of the basis of the relinquished property. This means that the deferred gain will be realized when the replacement property is sold. The taxpayer will also have lower depreciation deductions.

(2) There will be increased transactional costs for entering into and completing a tax deferred exchange. These costs include pos-sible additional escrow fees, attorney's fees, accounting fees, and the intermediary's and accommodation titleholder's fees where applicable.

(3) The taxpayer may not (without tax consequences) use any of the net proceeds from the disposition of the property for anything except reinvestment

Before deciding whether or not to engage in an exchange, the taxpayer should carefully analyze all of his or her options. A decision should NOT be based solely on the tax consequences of the transaction. Rather, business considerations should play the dominant role in the decision. Business considerations include, but are not limited to the need or desire to:

- consolidate (or diversify) investments;
- obtain greater appreciation on the real property;
- increase cash flow;
- relocate a business investment;
- eliminate management problems.

Once all of the factors have been considered, a taxpayer may, or may not, decide to engage in a tax deferred exchange.

THE PARTIES AND PROPERTIES IN AN EXCHANGE

There are four parties involved in a typical tax deferred exchange: the Taxpayer, the Seller, the Buyer, and the Intermediary.

- The Taxpayer (also called the Exchangor): the taxpayer has property and would like to exchange it for new property. The same taxpayer must dispose of the Relinquished Property and acquire the Replacement Property (the same taxpayer includes a disregarded entity such as a single member limited liability company).
- The Seller: the seller is the person who owns the property that the taxpayer wants to acquire in the exchange.
- The Buyer: the buyer is the person with cash who wants to acquire the taxpayer's property.
- The Intermediary: the intermediary plays a role in almost all exchanges today. It is usually a corporation or limited liability company. It may also be called a qualified intermediary or "QI." It neither begins nor ends the transaction with any property. It buys and then resells the properties in return for a fee. The Intermediary cannot be related to the taxpayer.

The party who acquires the taxpayer's relinquished property is NOT the same party who owns the replacement property. The typical exchange is NOT a swap whereby two individuals swap properties with one another.

The taxpayer who disposes of the relinquished property must also acquire the replacement property to make the exchange work. The taxpayer cannot have a spouse, partnership, multi-member limited liability company or other person acquire the replacement property. However, a limited liability company of which the taxpayer is the only member may acquire the replacement property because it is not a separate entity for federal tax purposes.

The properties involved in an exchange have special names too:

- The Relinquished Property: the property originally owned by the taxpayer and which the taxpayer would like to dispose of in the exchange.
- The Replacement Property: the new property, that is, the property that the taxpayer would like to

acquire in the exchange.

In order for an exchange to be completely tax deferred, the replacement property must have a fair market value greater than the relinquished property and all of the taxpayer's equity or more must be used in acquiring replacement property. This is known as **trading up in value and up in equity**, and it is essential for a totally tax deferred exchange.

Here is an example of the parties and properties involved in a typical exchange:

Party	Owns/Has	Wants
Taxpayer (Tom)	Tacoma Apartments	Boston Apartments
Buyer (Bart)	Cash	Tacoma Apartments
Seller (Sally)	Boston Apartments	Cash
Intermediary (QI)	Nothing	Nothing (except to buy and sell the properties for a fee)

Relinquished Property:
Tacoma Apartments (FMV $500,000)
Replacement Property:
Boston Apartments (FMV $750,000)

Tom owns an apartment complex in Tacoma worth $500,000. He believes the Tacoma Apartments are no longer appreciating in value and accordingly wants to dispose of them. However, he doesn't want to pay tax on the disposition of the Tacoma Apartments. While he wants to dispose of the Tacoma Apartments, he wants to acquire a larger property – the Boston Apartments.

Sally owns the Boston Apartments, worth $750,000. She feels that the Boston Apartments are no longer a good investment for her. She doesn't want any other real estate; instead, she wants to sell the Boston Apartments for cash.

Bart has money. He would like to buy the Tacoma Apartments for cash.

Through the assistance of QI, the intermediary, each of the parties will end up with what he or she wants. When the exchange is complete, Tom will own the Boston Apartments, Bart will own the Tacoma Apartments, and Sally will have cash.

TYPES OF EXCHANGES

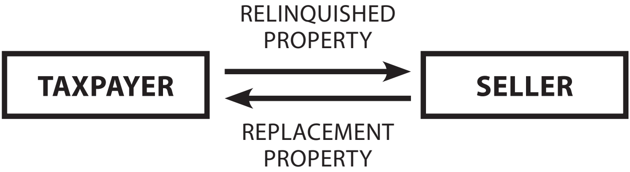
There are a number of different ways tax deferred exchanges can be structured. They may involve two, three, or four parties, and they may be quite simple or very complex. The most common structures are explained below involving exchanges using qualified intermediaries. Reverse exchanges are discussed later.

A. The Two-Party Exchange

Two-party exchanges are rare, since in the typical Section 1031 transaction, the seller of the replacement property is not the buyer of the taxpayer's property.

The two-party exchange, or swap, is the purest form of exchange. As the name implies, only two parties are involved and they exchange their properties. Both steps of the transaction occur simultaneously.

Title to the relinquished property is conveyed by the taxpayer to the seller and title to the replacement property is conveyed by the seller to the taxpayer.



Using our hypothetical characters and properties, Tom exchanges his Tacoma Apartments for Sally's Boston Apartments. (Sally is in effect both the buyer and the seller in this type of exchange.) The result is that Tom has title to the Boston Apartments (with a higher market value than the Tacoma Apartments) and Sally now has title to the Tacoma Apartments.

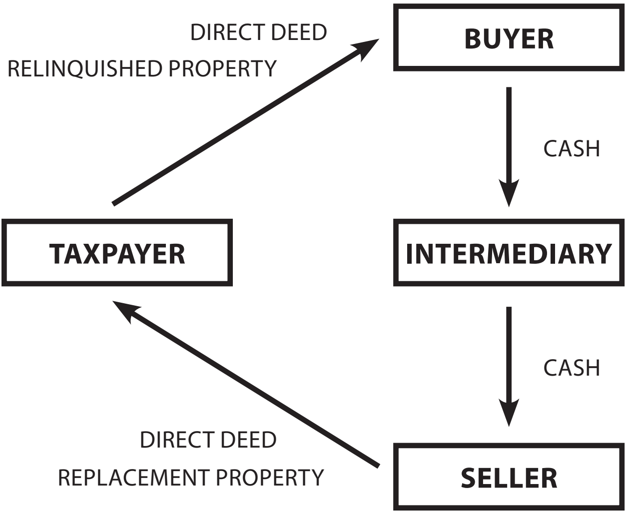
In a two-party exchange, the properties are rarely of equal value, so in addition to the title transfer, one party or the other will pay cash to equalize or balance the equities.

B. The Simultaneous Exchange with Intermediary

Most exchanges today employ the services of an intermediary – a straw party whose sole purpose in the transaction is to facilitate the exchange.

In a simultaneous exchange with an intermediary, title to the relinquished property is transferred directly to the buyer. The buyer pays cash to the intermediary. The intermediary pays cash to the seller who transfers title to the replacement property directly to the taxpayer.

The taxpayer thus avoids receiving any cash during the transaction, which would be immediately taxable.



In our example, Tom transfers title to the Tacoma Apartments to Bart. Bart pays the cash to QI and QI pays the cash to Sally. Sally then transfers title to the Boston Apartments to Tom.

The exchange must be properly documented in accordance with IRS regulations.

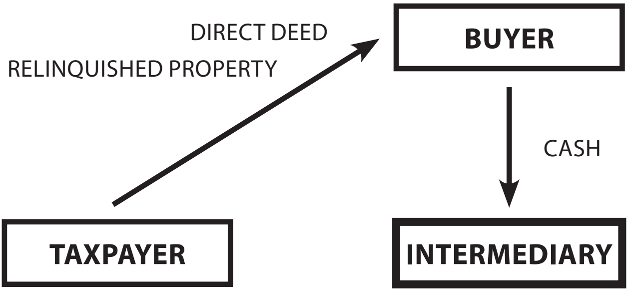
C. The Deferred Exchange with Intermediary

At the time when the relinquished property is transferred to the buyer, the taxpayer often does not yet know what property he or she wants to acquire. When that is the case, a deferred exchange is necessary.

The structure of the deferred exchange with intermediary is essentially the same as the simultaneous exchange with intermediary, except that, because the replacement property is not known at the time the reLinquished property is transferred to the buyer, the two legs of the exchange take place at different times.

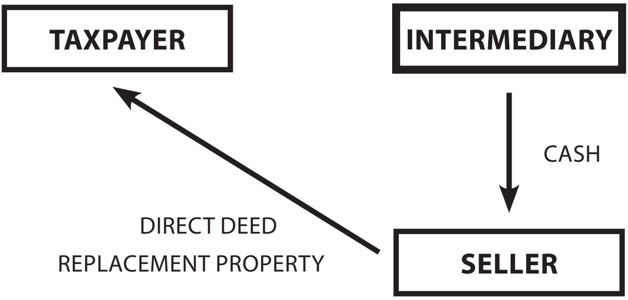
The taxpayer has 45 days to identify the property he or she wants as the replacement property. The transfer of the replacement property must still close within 180 days of the transfer of the relinquished property.

First Leg:



The delay after closing on relinquished property can be no more than 180 days.

Second Leg:



Example: Tom knows that he wants to dispose of the Tacoma Apartments, and Bart knows that he wants to buy the Tacoma Apartments for cash. Tom does not want to sell the Tacoma Apartments directly to Bart in a taxable sale and then buy another property at a later time. He wants to do an exchange. But at this time, Tom doesn't know what property he wants in exchange for the Tacoma Apartments.

The first leg of the transfer takes place as before: the title to the Tacoma Apartments is transferred to Bart, Bart pays cash to QI. Sometime later, but within 45 days, Tom identifies the Boston Apartments as the property he wants. Within 180 days of the transfer of the Tacoma Apartments, QI uses the funds from the first leg of the transaction to pay cash to Sally who then transfers title to the Boston Apartments to Tom. The exchange must be properly documented in accordance with IRS regulations.

SPECIFIC REQUIREMENTS FOR A VALID EXCHANGE

In order for a transaction to qualify for tax deferred treatment under Section 1031, certain requirements must be met. We have already touched on some of those requirements briefly. We will examine each of them in more depth now.

A. Qualified Property

In general, all property, both real and personal, can qualify for tax deferred treatment. However, some types of property are specifically disqualified, namely: stock in trade or other property held primarily for sale including REIT shares; stocks, bonds, notes; other securities or evidences of indebtedness or interest; interests in a partnership or multi-member limited liability company; certificates of trust or beneficial interest; and choses in action (i.e. interests in law suits). A percentage interest in property as a tenant in common is qualified property if the tenancy in common is carefully structured to avoid recharacterization as a partnership for federal tax purposes.

B. The Purpose Requirement

Not every type of property is eligible for tax deferred treatment. Both the relinquished property and the replacement property must be held for productive use in a trade or business or for investment. Thus, the taxpayer cannot exchange into or out of the taxpayer's own personal residence, or property held for resale as a dealer. Under an IRS safe harbor, a taxpayer may exchange out of a vacation home if it is rented out by the taxpayer to unrelated persons at a fair rental value for at least 14 days per year for the two consecutive years prior to the exchange, and the taxpayer and related persons do not use the vacation home for more than 14 days per year (or 10% of the rental days, if greater). Similar requirements apply if the taxpayer wants to exchange into a vacation home as replacement property. It must be rented to unrelated persons for at least 14 days per year for the two years following the exchange and the taxpayer and related persons may not use it more than 14 days per year (or 10% of the rental days, if greater).

C. The Like-Kind Requirement

Replacement property acquired in an exchange must be "like-kind" to the property being relinquished. Like-kind means "similar in nature or character, notwithstanding differences in grade or quality." All real property is like-kind, regardless of whether it is improved or unimproved and regardless of the type of improvement.

Therefore, raw land may be exchanged for land with a building, and one property may be exchanged for more than one property. Real property, however, is not like-kind to personal property.

Also, it is important to remember, that while real property can properly be exchanged for real proper ty, the Purpose Requirement discussed still applies; that is, the property, no matter what kind, must be held for productive use in a trade or business or for investment.

D. No Holding Period

How long must a taxpayer hold property in order for it to qualify for tax deferred treatment? The question applies both to the relinquished property and to the replacement property.

There is no holding period under Section 1031, just the Purpose Requirement. For example, if a replacement property is acquired and then immediately sold, it appears that the property was, in fact, acquired for resale. Unless the taxpayer can prove that the property was acquired for long term hold but circumstances changed after acquisition prompting the resale, the exchange cannot qualify for tax deferred treatment. A one year holding period is commonly used as a rule of thumb, but has no basis in statutory or case law. Two years is more prudent and has some basis in IRS rulings.

E. The Exchange Requirement

Section 1031 specifically requires that an exchange take place. Thus, one property must be exchanged for another property, rather than sold for cash. The exchange requirement distinguishes a Section 1031 tax deferred transaction from a taxable sale and purchase. The exchange is created by using the intermediary and the required exchange documentation.

F. Time Limits

There are two important time limits if the taxpayer will acquire the replacement property after the transfer of the relinquished property: (1) The taxpayer is required to identify the replacement property within 45 days after the transfer of the relinquished property, AND (2) the taxpayer must close on the replacement property before the earlier of (a) 180 days after the transfer of the relinquished property, or (b) the due date of the taxpayer's federal income tax return (including extensions) for the year in which the relinquished property is transferred. There are no extensions on these time limits, including for holidays or weekends.

Likewise, there are no exceptions to these time limits, other than for Presidentially declared disasters.

G. Identification Rules

Identification of all replacement property must be made in writing, must be signed by the taxpayer, and must be sent to a party to the exchange on or before midnight of the 45th day. The written identification is usually sent to the intermediary. The identification must be specific as to what the taxpayer intends to purchase. All identifications must give either the street address or legal description of the property and state that the taxpayer is identifying it as replacement property. If improvements are to be constructed on the property, they must be described in as much detail as practically possible.

The taxpayer may identify one or more properties in the written identification. In general, the number of replacement properties that may be identified is:

(1) Up to three properties, without regard to their fair market value (The Three-Property Rule);

(2) More than three properties, but the total fair market value of all these properties at the end of the 45-day identification period does not exceed 200% of the total fair market value of all properties relinquished in the exchange (The 200% Rule).

Any property actually received during the 45-day identification period is treated as properly identified, but does count as a property for the purposes of the Three Property Rule or the 200% Rule if the taxpayer identifies additional replacement property in a written notice. If the taxpayer exceeds both the Three Property Rule and the 200% Rule, then the properties acquired after the 45th day do not count as replace-ment property in the exchange (unless the taxpayer acquires 95% of all the identified properties).

H. Same Taxpayer Requirement

The taxpayer who disposes of the relinquished property must also acquire the replacement property in the exchange. The taxpayer cannot have a spouse, partnership, multi-member limited liability company or other person acquire the replacement property. However, the taxpayer may acquire the replacement property in a limited liability company (LLC) if the taxpayer is the sole member of the LLC because the LLC is not a separate entity for federal tax purposes.

I. Related Party Issues
Generally, if the taxpayer is selling the relinquished property to an unrelated party, then the taxpayer may not acquire his or her replacement property from a related party, such as a parent, child, spouse, or corporation or other entity in which the taxpayer or his or her immediate relatives own greater than 50%. There are some limited exceptions to this rule, such as when the related party is also doing an exchange, or is paying as much tax as the taxpayer is deferring. Also, a taxpayer and a related party may do a two-party swap between each other if the taxpayer and the related party each then hold their replacement property for two years.

J. New Construction as Replacement Property
If the taxpayer wants to include new construction as replacement property, then the construction must be done prior to the date that the taxpayer acquires title to the replacement property. Any construction occurring after the taxpayer acquires title does not qualify as like kind replacement property in the exchange. Typically, the qualified intermediary or accommodation titleholder will acquire title to the replacement property, use the exchange funds for the construction, and then transfer title to improved property to the taxpayer before the expiration of the 180 day time period. The construction does not need to be completed before the 180th day; partial construction also qualifies as replacement property for real property.

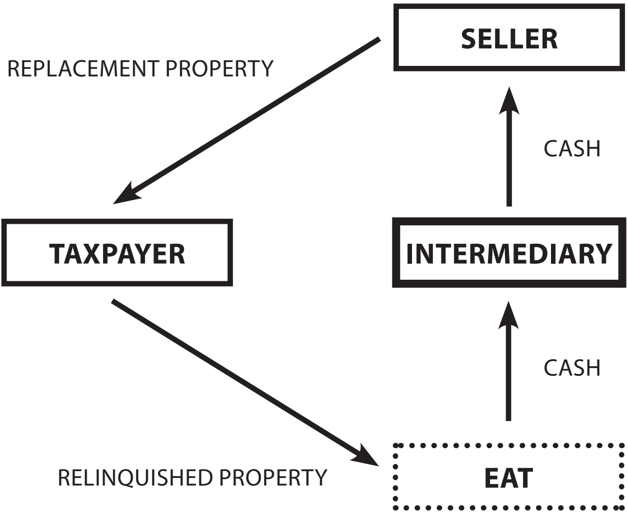
RECEIPT OF EXCHANGE PROCEEDS
The taxpayer may not receive all of the exchange proceeds, or the transaction will be treated as a taxable sale and not as an exchange. The taxpayer can receive a portion of the exchange proceeds at the closing of the relinquished property or the end of the exchange and pay the taxable gain on just that portion received. Even if the taxpayer does not actually receive the exchange proceeds, the exchange will be disallowed if the taxpayer is considered to have "constructively" received them. The IRS Regulations provide that the exchange proceeds will be treated as constructively received by the taxpayer (and therefore taxable) if the proceeds are credited to the taxpayer's account, set apart for him or her, or otherwise made available so that the taxpayer may draw upon them at any time. However, the exchange proceeds are NOT constructively received if the taxpayer's control is subject to substantial limitations. The principal means of avoiding constructive

receipt is the use of a qualified intermediary. In addition, a guarantee, qualified escrow or qualified trust may be used under the Regulations to secure the taxpayer's interest in the funds. A taxpayer may receive the interest earned on the exchange funds without impacting the exchange, provided the interest is not actually paid to the taxpayer until the completion of the exchange.

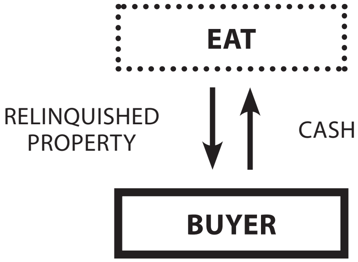
REVERSE EXCHANGES

If the Taxpayer has found his or her replacement property and must close on it prior to the time that the relinquished property is ready to close, then the transaction becomes a "reverse exchange." The language of IRC Section 1031 does not provide for or prohibit reverse exchanges, but only provides for forward deferred exchanges. The IRS has created a safe harbor for reverse exchanges that uses the parking procedures discussed below. Two structures are provided for:

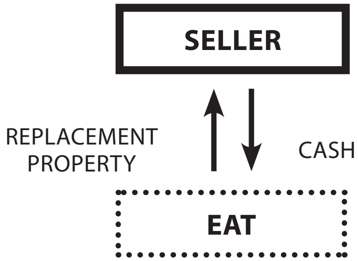
A. Relinquished Property Parked. In the first structure, the exchange occurs with the taxpayer acquiring the replacement property and conveying the relinquished property to the Exchange Accommodation Titleholder ("EAT"), using an exchange intermediary. This type of transaction may be diagrammed as follows:



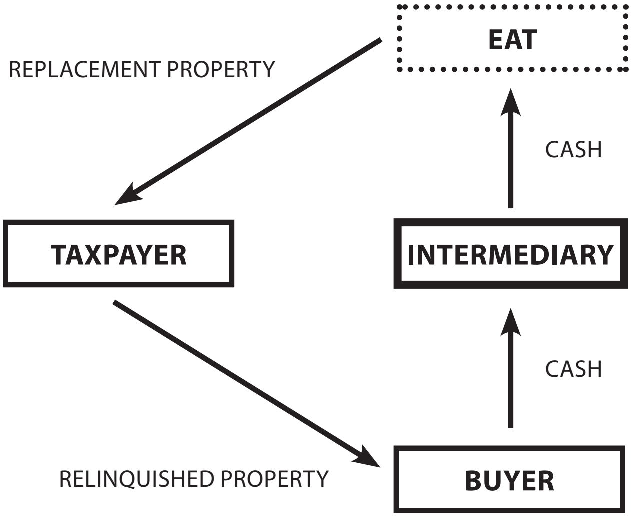
No more than 180 days later:



B. Replacement Property Parked. In the second structure, the EAT acquires the replacement property. The EAT may construct improvements on the property if needed. When the taxpayer's relinquished property is ready to close, then the taxpayer will exchange the relinquished property for the replacement property through an exchange intermediary. This type of transaction may be diagrammed as follows:



No more than 180 days later:



C. The Mechanics. In reverse exchanges, the EAT cannot be the taxpayer or a disqualified person (basically a person related to the taxpayer, including an entity in which the taxpayer owns 10% or more, or the taxpayer's attorney, CPA, real estate agent or employee) and must be subject to federal income tax. The EAT must hold title to the property at all times from the date of acquisition by the EAT until the property is transferred. The taxpayer and the EAT must enter into a written agreement and the EAT must be treated as the beneficial owner of the property for all federal income tax purposes. The EAT may lease the parked property to the taxpayer or the taxpayer may manage it.

If a taxpayer has several potential relinquished properties that he or she may sell, then the taxpayer may take up to 45 days after the EAT's acquisition of the replacement property to identify which relinquished property will be exchanged. And the taxpayer may identify up to 3 alternative relinquished properties, or any number so long as their total value does not exceed 200% of the value of the parked replacement property.

The reverse exchange period under the safe harbor is a maximum of 180 days. If the reverse exchange time period exceeds 180 days, then the exchange is outside the IRS safe harbor. This means that the IRS can challenge the reverse exchange. A proper reverse exchange can be structured to go beyond 180 days, but the EAT must not be considered the taxpayer's agent and have benefits and burdens of ownership.

D. Considerations. A taxpayer entering into a reverse exchange must consider the following issues:

Can the taxpayer be sure that the relinquished property will sell within 180 days to come within the safe harbor? If not, the reverse exchange will have to be structured so that the EAT has more benefits and burdens related to the parked property. It will be more costly and more subject to attack by the IRS.

How will the taxpayer finance the acquisition of the replacement property without the proceeds from the sale of the relinquished property? The taxpayer will need funds from another source or a bridge loan will have to be arranged.

If financing is being obtained on the replacement property in a Type B exchange (replacement property parked), will the lender allow an EAT to take title rather than the taxpayer?

Are enough taxes being deferred to justify the additional costs, such as EAT fees, recording fees, state and local real estate transfer taxes, extra title insurance and accounting fees? These can be much more substantial than a standard deferred exchange.

Is there a method to avoid additional state or local transfer taxes for the parked property?

Are there due-on-sale problems with the loan in a Type A exchange (relinquished property parked)?

E. Combination Exchanges. A reverse exchange can be combined with a deferred exchange. For example, the taxpayer can exchange into a 50% undivided interest in a replacement property in a deferred exchange. The EAT can then acquire the remaining 50% undivided interest in that replacement property and hold it for up to 180 days while the taxpayer sells a second relinquished property to exchange for the parked portion.

TAX CONSEQUENCES OF EXCHANGING

Determining the tax consequences of an exchange transaction begins with an understanding of the terms "basis," "adjusted basis," "gain," and "boot."

Basis. "Basis" is the starting point for determining the tax consequences in any transaction. In most cases, a taxpayer's "basis" in his or her property is the cost of the property. For example, let's say that the taxpayer, Tom, purchased his property, the Tacoma Apartments, for $225,000. So Tom's basis in the Tacoma Apartments is $225,000.

Adjusted Basis. The next step in determining the specific tax consequences in an exchange is to establish the "adjusted basis" of the relinquished property. To determine the "adjusted basis," take the basis (the cost of the property) and add the cost of any capital improvements made to the property during the taxpayer's ownership, and subtract any depreciation taken on the property during that same time period.

Tom's basis in the Tacoma Apartments is $225,000. During the time he owned the property, he made $25,000 worth of capital improvements to the property, and took $50,000 worth of depreciation. Therefore, Tom's adjusted basis in the property is $200,000.

$225,000	**basis in property**
+ $25,000	**capital improvements**
- $50,000	**depreciation**
$200,000	**adjusted basis**

Even if a taxpayer's adjusted basis in a property is greater than his or her basis, no tax is owed until there is a gain, and there is no gain until the property is transferred.

Gain. There are two types of gain: "realized gain," and "recognized gain."

"Realized gain" is the difference between the total consideration (cash and anything else of value) received for a property and the adjusted basis. Transaction costs such as commissions and recording costs are deducted from realized gain. If Tom were to sell the Tacoma Apartments for $500,000 net of closing costs, his gain would be the difference between the consideration received ($500,000) and his adjusted basis in the property ($200,000), or $300,000:

	$500,000	**consideration received**
-	**$200,000**	**adjusted basis**
	$300,000	**gain**

"Recognized gain" is that portion of the "realized gain" which is taxable. Realized gain is not taxable until it is recognized. Gain is usually, but not always, recognized in the year in which it is realized.

In an exchange that qualifies under Section 1031, realized gain is recognized to the extent that "boot" is received (see below). However, the amount of gain recognized is always limited to gain realized or the boot received, whichever is the lesser amount. Therefore, for a transaction to result in total nonrecognition of gain, the taxpayer must receive property with an equal or greater market value and equity investment than the property exchanged, and receive no boot.

Looking at our example, Tom was able to conduct an exchange which resulted in total tax deferral. He acquired the Boston Apartments, a property which was greater in value than the Tacoma Apartments. He placed $500,000 of debt on the Boston Apartments, which was greater than the debt he was relieved of on the Tacoma Apartments ($250,000). The $250,000 netted from the Tacoma Apartments was used as a down payment on the Boston Apartments.

Tom's adjusted basis in the Tacoma Apartments was $200,000. The gain on the Tacoma Apartments was $300,000 (that is, the difference between the consideration received for the property and the adjusted basis). By exchanging the Tacoma Apartments, Tom deferred the total tax that otherwise would be due on the gain.

Simple Rule of Thumb: To totally defer gain, you must trade up or equal in value and equity.

Boot. In an exchange of real property, any consideration received other than real property is "boot." There are two types of boot: "cash boot" and "mortgage boot." Cash boot is cash or anything else of value received. Mortgage boot is any liabilities assumed in the exchange.

Assume, for example, that the outstanding debt on the Tacoma Apartments is $250,000, and that Tom puts $250,000 down on the Boston Apartments and assumes the remaining debt of $500,000.

Thus, Tom received mortgage boot in the amount of $250,000 (the amount of debt on the Tacoma Apartments that he was relieved of in the transaction). Because a debt of $500,000 was placed on the Boston Apartments, Tom is considered to have paid or given mortgage boot in this exchange. The amount of mortgage boot received ($250,000) is more than offset by the amount of mortgage boot given ($500,000).

Basis in the Replacement Property. In an exchange, the tax is deferred by carrying over the taxpayer's adjusted basis in the relinquished property to the replacement property. So Tom's adjusted basis in the Tacoma Apartments is carried over to the Boston Apartments.

The basis is increased, however, from $200,000 to $450,000 because the difference between the boot given and the boot received is added to the adjusted basis (that is, the *additional debt* on the replacement property):

	$200,000	**adjusted basis in relinquished property**
-	**$250,000**	**additional debt on replacement property**
	$450,000	**basis in replacement property**

Here is a summary of the calculations that our hypothetical taxpayer might do when considering a 1031 exchange:

a) Taxpayer Tom owns the Tacoma Apartments with the following values:

$500,000	**fair market value (net of closing costs)**
$250,000	**outstanding debt on the property**
$200,000	**adjusted basis**

b) If Tom were to sell the Tacoma Apartments, he would incur a tax liability of $50,000 calculated as follows:

	$500,000	**sale price**
-	**$200,000**	**adjusted basis**
	$300,000	**gain**

Taxed as follows:

	$50,000	**depreciation recapture**
x	**.25**	
	$12,500	**tax**

Plus:

	$250,000	**profit**
x	**.15**	
	$37,500	**tax**

Tax liability: $50,000

There may be additional state tax liability.

CONCLUSION

It should be obvious from the topics discussed in this booklet that tax deferred exchanges require advance tax planning and attention to structuring formalities. The purpose of this booklet is to bring attention to the opportunities available in engaging in a tax deferred exchange as an investment strat-egy. The application of Section 1031 to a particular transaction or property can only be determined after careful study of a taxpayer's particular facts and circumstances, and analysis by his or her tax advisor, attorney, real estate agent, and intermediary.

GLOSSARY

EAT: The exchange accommodating party who holds title to the parked property in a reverse exchange.

Intermediary: An entity that acts as qualified intermediary or "QI" for the taxpayer in return for a fee.

Relinquished Property: The property being sold by the Taxpayer in the exchange.

Replacement Property: The property being purchased by the Taxpayer in the exchange.

Taxpayer: The individual or business owning the assets being exchanged. The same taxpayer must dispose of the relinquished property and acquire the replacement property (the same taxpayer includes a disregarded entity such as a single member limited liability company).

Notes:

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Land Title
Exchange Corporation

5975 Greenwood Plaza Blvd.
Greenwood Village, CO 80111
303-321-1880

www.landtitleexchangecorporation.com

Member of The Federation of Exchange Accomodators
www.1031.org

For Exchange questions please contact any of our 1031 Exchange Coordinators with the direct lines below:

Brieana: 303-694-5347
Kacey: 303-850-4133

email: 1031exchange@ltgc.com