PETKOVSEK & MORAN, LLP
CERTIFIED PUBLIC ACCOUNTANTS AND CONSULTANTS

§1031 Tax-Deferred Exchanges

Welcome to the wonderful world of IRC Section 1031 Exchanges. This is an excellent tax and financial tool that allows real estate investors to maximize their investment. Petkovsek & Moran is very well versed in using this strategy and has assisted investors, Realtors, developers, accountants, attorneys, title companies and others on more than 300 exchanges.

The strategy is available to ALL owners of real estate, not just the wealthy. A tax-deferred exchange is quite affordable, although it is very technical and requires expert knowledge to navigate the many requirements. One missed step will cause the exchange to fail and all taxes become due at once.

Learn more about IRC §1031 Exchanges:

- Major Benefits
- Top 10 Reasons To Use
- Sell vs. Exchange
- Are you a Candidate for an Exchange
- Qualified Property
- Nonqualified Property
- Exchange Timeline
- Exchange Intermediary
- Planning Strategies & Opportunities

Give us a call or send us an email. Petkovsek & Moran can help you through the IRC 1031 maze.

4001 Nakoosa Trail, Suite 200 ● Madison, WI 53714-1355 ● www.pmcpas.com ● FAX 608.221.3033 ● TEL 608.221.3268

Major Benefits

IRC §1031 provides two major benefits to real estate investors … building wealth and increase the effectiveness of your investment.

Building wealth occurs by –

- Deferring payment of the income taxes on the sale of property to a future date.
- Leveraging your deferred taxes to increase the value of your real estate purchases (generally five times the amount of the taxes deferred).

Increase the effectiveness of the real estate you own by –

- Trading a nonproductive asset (e.g., vacant lot) for an income producing property.
- Moving your real estate investment dollars to a more suitable geographic location, whether it is across town or to another state.
- Ability to reduce your time commitment to manage the property.

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Top 10 Reasons for a 1031 Exchange

Each exchange transaction is unique to the investor's personal circumstances. The course of action depends on many factors. Here are the primary reasons to consider an IRC §1031 Exchange:

1. Accumulate wealth by deferring, or possibly eliminating, income taxes on the sale.
2. Use your total equity from the sale to acquire replacement property.
3. Enhance cash flows on your investment dollars.
4. Reduce or eliminate your management responsibilities by upgrading your investment portfolio.
5. Relocate investment property to a more desirable location.
6. Consolidate or diversify real estate investments.
7. Convert nonproductive property (e.g., raw land) into income generating property (e.g., apartment building).
8. Trade LOW basis property for HIGH basis property to enhance tax benefits with depreciation deductions.
9. Use the exchange as an estate planning tool.
10. It makes sense whether income and capital gain tax rates are high or low.

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Sell vs. Exchange

What is the difference?

SELLING is the disposition of the old property, taking possession of the equity proceeds and then reinvesting in other properties. This process is accomplished in TWO or MORE unrelated transactions with no connecting documentation. Income taxes must be paid in the year of sale and will reduce the amount of equity available to reinvest in other property.

EXCHANGE is the same as selling, *except* the process of disposing and reinvesting are tied together into ONE related transaction by the exchange agreement. All of your equity proceeds are available to acquire more property and the income taxes are postponed indefinitely.

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Are you a Candidate for an Exchange?

If you answer YES to any of the following questions, you are a candidate for a 1031 exchange:

1. Are you tired of managing your real estate investments?
2. Would you like to stay invested in real estate?
3. Will you realize a significant income tax cost on the sale of your old property?
4. Do you desire to reinvest all or most of your equity proceeds?
5. Will the value of the NEW property be more than the value of the old property?
6. Will the amount of debt on the NEW property be more than the debt on the old property?
7. Do you believe you are better than the government at wisely investing the income tax dollars on the property sale?

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Qualified Property

Qualified real estate property must meet ALL three of these tests:

1. Both the relinquished property (surrendered) and the replacement property (acquired) in the exchange must be held by the taxpayer for "investment" or "trade or business use."

2. The relinquished property is "exchanged" for the replacement property in one related transaction. This is in contrast to "selling" the property and "reinvesting" the proceeds in another property by two separate transactions.

3. The relinquished and replacement properties must be of "like-kind". When it comes to real estate, IRC §1031 has a very broad definition. For instance, an office building can be traded for farmland. However, there are restrictions on certain property such as your personal residence, “inventory” type real estate, etc. Please call us to determine the qualifications of your opportunity.

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Nonqualified Property

Types of property that do not qualify for an IRC §1031 Exchange:

- Stock in trade (inventory) or other property held primarily for resale.
- Stocks, bonds, notes, certificates of deposit.
- Other securities or evidences of indebtedness or interest.
- Certificates of trust or beneficial interests.
- Choses in action - a right to recover or receive money, property or other consideration.
- Ownership interest in a partnership. However, some exceptions may apply if –
  - The partnership has a valid election under IRC 761(a) to be excluded from the partnership tax rules.
  - The partnership dissolves and distributes the real estate to the partners as tenants in common (TIC). Each TIC then exchanges his/her interest in the real property for a separate replacement property under IRC §1031.

NOTE: Receipt of the above items as “boot” proceeds in an exchange transaction will be taxable to the extent of the realized gain on the relinquished property.

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Exchange Timeline

Two very significant attributes of an IRC §1031 Exchange are that deviations in procedures and extension of time to complete tasks are NOT allowed. In addition, the exchange agreement must be in place *before* the first property closing. The 45-day and 180-day timelines run simultaneously beginning on Day 1. The timeline is measured in *calendar* days, not business days.

DAY 1
- Exchange timeline begins on the first day *after* closing.
- If multiple properties will be traded, this timeline begins with the FIRST relinquished property to close.

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DAY 45

- Identification deadline to name your choice of replacement property.
- Must be written and formally accepted by the Intermediary by the 45th day.
- Property description must be unambiguous.
- Three (3) property rule.
- 200% property rule.
- Can add and delete numerous properties up to this day.
- Identification procedure is satisfied if you acquire *and* take title to the replacement property within the 45 days.

DAY 180

- Final day to acquire replacement property and take title.
- If new construction, the replacement property need not be finished to qualify for exchange.
- Only the value on the date acquired is applicable to the exchange. Improvements made after the acquisition date do not count towards the required exchange reinvestment value.

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Exchange Intermediary

What is it and how does it figure into the transaction?

When an IRC §1031 Tax-Deferred Exchange is *not* simultaneous, which is most always the case, a qualified intermediary is required to hold the funds and facilitate the exchange transaction by use of an Exchange Agreement.

- Qualified intermediary is a safe-harbor middleman created by the Internal Revenue Code.
- Usually is a title insurance company.
- Facilitates the exchange process according to the terms of an exchange agreement.
- Cannot be a "disqualified person", which is someone who has acted as your agent within the past two years such as a:
  - Realtor
  - Employee
  - Accountant
  - Attorney
  - Investment Broker
  - Relatives

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Planning Strategies & Opportunities

Petkovsek & Moran, LLP intimately understands the IRC 1031 Exchange process. Our experience can have a great impact on the success of your exchange. Our familiarity with the process will help you build more flexibility into each transaction, such as:

- How to effectively create *extra time* to meet the 45 & 180-day timelines.
- Identify sufficient number of properties to protect your interests.
- If the tax consequence is significant, an exchange agreement can provide you more time to make final decisions. Even if you decide not to complete the exchange.
- Possibly shift the tax burden from one year to the next.
- Awareness of the interplay between the exchange timeline and due date of your income tax return.

You owe it to yourself to discuss the exchange opportunities with a professional before you sell your property. Remember, either the IRS spends your money (tax dollars), or you keep it and choose how to invest.

Give us a call or send us an email. Petkovsek & Moran, LLP can make it happen for you.

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