1031 Tax-Deferred Exchange Issues in 2025

THE POWER OF EXCHANGE

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Presented by

Stephanie Kelsey – Division Manager, So Cal

Asset Preservation, Inc.

Disclaimer

This presentation is only intended to provide a broad overview of IRC Section 1031 tax-deferred exchanges and does not address every potential 1031 exchange situation or all applicable 1031 exchange rules.

This tax-related information should not be construed as tax or legal advice specific to your situation and should not be relied upon in making any business, legal or tax related decision. A proper evaluation of the benefits and risks associated with a particular transaction or tax return position often requires advice from a competent tax and/or legal advisor familiar with your specific transaction, objectives and the relevant facts. You are urged to involve your tax and/or legal advisor (or to seek such advice) in any significant real estate or business related transaction.

Asset Preservation

- API is a leading national qualified intermediary (QI) and has facilitated over 200,000 1031 exchanges
- We are one of the largest QI's in the United States
- Established in 1990, over 30 years of experience with 1031 exchanges
- Member in good standing with the FEA (Federation of Exchange Accommodators)
- Subsidiary of Stewart Information Services Corporation (SISCO) a NYSE publicly traded company

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What we are covering today

- IRC Section 1031: Tax deferral on the sale of a property used in a trade or business or held for investment when exchanged for like-kind replacement property.
- Capital Gains Taxes
- Exchange Entities
- Like-Kind Property
- Delaware Statutory Trusts
- Vacation Homes
- Holding Period
- Delayed and Reverse Exchange
- Identification Rules

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Hold, Sell or Exchange?

Taxpayers owning investment real property face three options:

- **1) Hold:** Wait as the market continues to come back (but there is an opportunity cost for taxpayers owning real estate in areas where growth is low and appreciation is expected to be low.)
- **2) Sell:** Sell the property and pay taxes owed. Invest the net equity (after taxes) in other investments outside of real estate. The challenge: Obtaining the same ROI with *after-tax* funds outside of real estate versus the ROI on gross equity *pre-tax* reinvested in investment real estate.
- **3) 1031 Exchange:** Defer all capital gain taxes with a fully deferred 1031 exchange or receive some "boot" through a partially deferred exchange. Redeploy equity that would have been used to pay capital gain taxes into the purchase larger replacement property or properties.

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Investor Motives

Investors increase their rate of return by using:

- Leverage
- Diversification (Asset or Geographic)
- Consolidation
- Cash flow
- Management relief
- Estate planning

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Selling Appreciated Property

- IRC Section 1031: Tax deferral on the sale of a property used in a trade or business or held for investment when exchanged for like-kind replacement property.
- IRC Section 1033: Involuntary conversion, eminent domain.
- IRC Section 121: Tax exclusion on the sale of a principal residence held for two of out five years ($250K single/$500K married filing jointly).
- IRC Section 453: Seller financing (installment sale).
- IRC Section 721: Tax deferral when a REIT acquires a property, and the taxpayer receives operating units (“OP units”) in the REIT. Referred to as an “UPREIT” transaction.

1031 vs 1033 Exchanges

1031 Exchange – Voluntary

- Need to use a Qualified Intermediary to hold the funds
- Strict timelines – 45-day ID period – 180 days to close on new property after COE
- Must be investment property for like-kind investment property

1033 Exchange – Involuntary Conversion

- No Qualified Intermediary needed
- Funds go directly to the property owner - they can use the funds however they want until an acceptable replacement is found
- Timeline/deadlines for reinvestment can be from 2 years to 4+ years
- Primary residences are eligible for tax deferral strategy
- Replacement property “Similar or related in service or use”

IRC §1031 Exchanges

Taxpayers continue to explore strategies to reduce or defer taxes which has led to an increase in 1031 exchanges.

- Since 1921, one aspect of the tax code provides taxpayers who own investment real estate a significant tax advantage – an IRC Section 1031 tax-deferred exchange, more commonly referred to as a 1031 exchange.
- Section 1031 allows taxpayers holding real property for investment or business purposes to potentially defer all taxes that would otherwise be incurred upon an otherwise taxable sale of investment property.

Capital Gain Taxation

Capital gain taxation includes 4 components:

1) Taxation on depreciation recapture at 25%
2) Federal capital gain taxes at 20% (or 15%)
3) Net investment income tax 3.8%
4) The applicable state tax rate (0% - 14.4%)

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Sale versus Exchange

- Assume a married couple filing jointly sells an investment property in California for $1,000,000.
- The couple originally purchased the property for $400,000.
- 75% of the investment property is depreciable and the property has been fully depreciated.(27.5 years for res and 39 years for commercial)
- The capital gain is approximately $900,000 (today's sales price of $1,000,000 minus the net adjusted basis of $100,000)
- There are four levels of potential taxation: (1) depreciation recapture at 25% (2) federal capital gain taxes at either 15% or 20% (3) net investment income tax (NIIT) of 3.8%, when applicable (4) state taxes (0-14.4%), when applicable.
- This married couple will be at the 20% federal tax rate, the 3.8% net investment income tax and California taxes.

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Sale versus Exchange

Today's Net Sales Price (after closing costs) $1,000,000

Less: Taxes Owed:

- $300,000 deprecation recapture @ 25% = $75,000
- $600,000 federal capital gain @ 20% = $120,000
- $900,000 net investment income tax @ 3.8% = $34,200
- $900,000 state tax @ 13.3% = $119,700

Total taxes owed = $348,900

After-Tax Net Equity

Sales Price – Taxes Owed = Net Equity

$1,000,000 – $348,900 = $ 651,100

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Sale versus Exchange

Taxable Sale After-Tax Net Equity = $651,100

1031 Exchange Gross Equity = $1,000,000

Replacement Property Purchase

Taxable Sale: Net Equity x 4 = $2,604,400

1031 Exchange: Gross Equity x 4 = $4,000,000

* Almost $1.4M more replacement property by doing a 1031 exchange versus a taxable assuming a 75% LTV. Taxable sale after-tax net equity $651,100 x 4 = $2,604,400. 1031 exchange gross equity $1,000,000 x 4 = $4,000,000.

** The loan-to-value ratio (LTV) can vary based upon asset class and lender requirements. In many commercial transactions, it is common to have a 35% required down payment and financing on only 65% of the purchase price.

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The Code

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.

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Exchange Entities - General

Generally, the same tax owner should take title to the replacement property in the same manner they held title to the relinquished property. Some examples are below:

- Wife relinquishes, wife acquires
- Smith LLC relinquishes, Smith LLC acquires
- Gemco Corp. relinquishes, Gemco Corp. acquires
- Durst Partnership relinquishes, Durst Partnership acquires
- However, having the vesting the same is only a guideline.
- The key issue is the “tax owner” of the relinquished property must acquire tax ownership of the replacement property.

Like-Kind Property

Like-Kind Property

What Real Property is Excluded?

- Principal residence
- Property held for sale/dealer property (Flips)

Qualifying Real Property

Any relinquished real property held for productive use in a trade or business or for investment exchanged for replacement real property held for productive use in a trade or business or for investment.

Real Property Definition Can be Broad

Can include raw land, commercial, single-family rental (SFR), multi-family, office, industrial, easements, air rights, water rights, vacation homes held for investment under Rev. Proc. 2008-16, fractional ownership(DST), etc.

Vacation Homes

Revenue Procedure 2008-16

- Creates safe harbor for vacation home exchanges.
- IRS will consider a dwelling unit held for investment if certain requirements are met.

Requirements:

- The relinquished and replacement properties are owned by the taxpayer for at least 24 months (the qualifying use period)
- Within each of these two 12-month periods constituting the qualifying use period the taxpayer must:
  - Rent the property to another person or persons at fair market rent for 14 or more days (if a taxpayer rents to a related party/family member, they must both (A) pay fair market rents and (B) use the property as their principal residence.)
  - The taxpayer's personal use of the dwelling unit cannot exceed the greater of 14 days or 10 percent of the time it is rented.

Fractional Ownership: DST

- A Delaware Statutory Trust (DST) is a separate legal entity created as a trust under the laws of Delaware in which each owner has a “beneficial interest” in the DST and is treated as owning an undivided fractional ownership in the property.
- Only for an “accredited investor” (a high-net worth investor as defined in Regulation D of the Securities Act of 1933 – single income greater than $200,000 over the past 2 years. Joint income with spouse of greater than $300,000 for past 2 years OR have a net worth of at least $1M excluding Primary Residence).
- “Mailbox Money” Passive investment vehicle.
- Useful Estate Planning option
- Chief advantage of a DST is the lender views the trust as only one borrower.
- Investors only right to the property is receiving distributions and they have no voting authority regarding the operation of the property

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Split Treatment (§1031 and §121)

Sale of a Four Unit Property (Fourplex)

3 units rented (§1031)
1 unit used as a principal residence (§121)

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Convert Residence into a Rental

Convert Residence into a Rental (§121 convert to §1031)

- Revenue Procedure 2005-14 provides guidance for the concurrent application of §121 and §1031 if a taxpayer has converted a principal residence into a rental.
- Taxpayer must meet the requirements of §121 and have lived in the property for two (2) of the past five (5) years.
- Taxpayer has converted the principal residence into a rental.
- Taxpayer can exclude capital gain taxes up to the threshold amounts of §121 ($250,000 single; $500,000 married) – and perform a §1031 tax-deferred exchange into a replacement property under §1031 which is to be held for investment or used in a business.
- Taxpayer obtains tax exclusion pursuant to §121 and tax deferral pursuant to §1031.

Split Treatment (§1031 and §121)

$1 million residence with several Airbnb rooms

- $200,000 Airbnb portion (§1031)
- Residence portion $800,000 (§121)

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SPLIT TREATMENT (§1031 AND §121)

$750,000 Residence with 3 floors and 1/3 Home Office/ Basement ($250,000)

- $250,000 home office portion/ lower basement (§1031)
- $500,000 residence portion/ main floor & upper level (§121)

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Holding Period

- How Long Do I Need To Hold A Property Until I Do My Next 1031 Exchange Or Move Into The Property?

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Intent to Hold for Investment

Time is only one factor: The Taxpayer's **intent** is the key issue!!!

ONE PERSPECTIVE:

- 24 months or more
- In PLR 8429039, the IRS stated that a minimum holding period of two years would be sufficient
- Rev. Proc. 2008-16

SECOND PERSPECTIVE:

- Minimum of 12 months
- Straddles two tax filing years
- Over 12 months qualifies for long-term capital gain treatment
- Attempt by Congress in 1989 to impose one year holding period (which didn't pass)

No Cheaters!

CA realtor did an exchange of her Relinquished rental properties but acquired a residence as Replacement and used it as her principal residence. She obtained an owner-occupied loan on the Replacement. She falsely reported the Primary as a rental property and falsely reported rental income to “cover her tracks”. She also listed another rental as her residence address on her tax return. She pled guilty to tax evasion and did14 months in prison! *In the Matter of the Appeal of Cheryl A. Savage, 2016 WL 9526372 (CA BOE)*

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The Exchange Equation

For FULL tax deferral, a taxpayer must meet two requirements:

1. Reinvest all net exchange proceeds
2. Acquire property with the same or greater debt.

	Relinquished	Replacement	Boot
Value	$900,000	$1,200,000	
- Debt	$300,000	$660,000	$ 0
- Cost of Sale	$60,000		
Net Equity	$540,000	$540,000	$ 0

The taxpayer acquired property of greater value, reinvesting all net equity and increasing the debt on the replacement property.

Analysis: There is no boot.

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The Exchange Equation

	Relinquished	Replacement	Boot
Value	$900,000	$700,000	
- Debt	$300,000	$260,000	$ 40,000
- Cost of Sale	$60,000		
Net Equity	$540,000	$440,000	$ 100,000
Total Boot			$ 140,000

The taxpayer acquired property of a lower value, keeps $100,000 of the net equity and acquired a replacement property with $40,000 less debt.

Analysis: This results in a total of $140,000 in boot.
($40,000 mortgage boot and $100,000 in cash boot = $140,000)

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The Exchange Equation

	Relinquished	Replacement	Boot
Value	$900,000	$800,000	
- Debt	$300,000	$260,000	$ 40,000
- Cost of Sale	$60,000		
Net Equity	$540,000	$540,000	$ 0
Total Boot			$ 40,000

The taxpayer acquired property of a lower value, reinvesting all net equity, but has less debt on the replacement property.

Analysis: This results in $40,000 in mortgage boot.

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Steps To Take Prior To The Exchange

1. Have your client consult their tax advisor

2. Consult a Qualified Intermediary

3. Confirm who is the taxpayer that owns the property (do not rely solely on the title report)

4. Confirm that the purchase agreement matches the title and tax ownership

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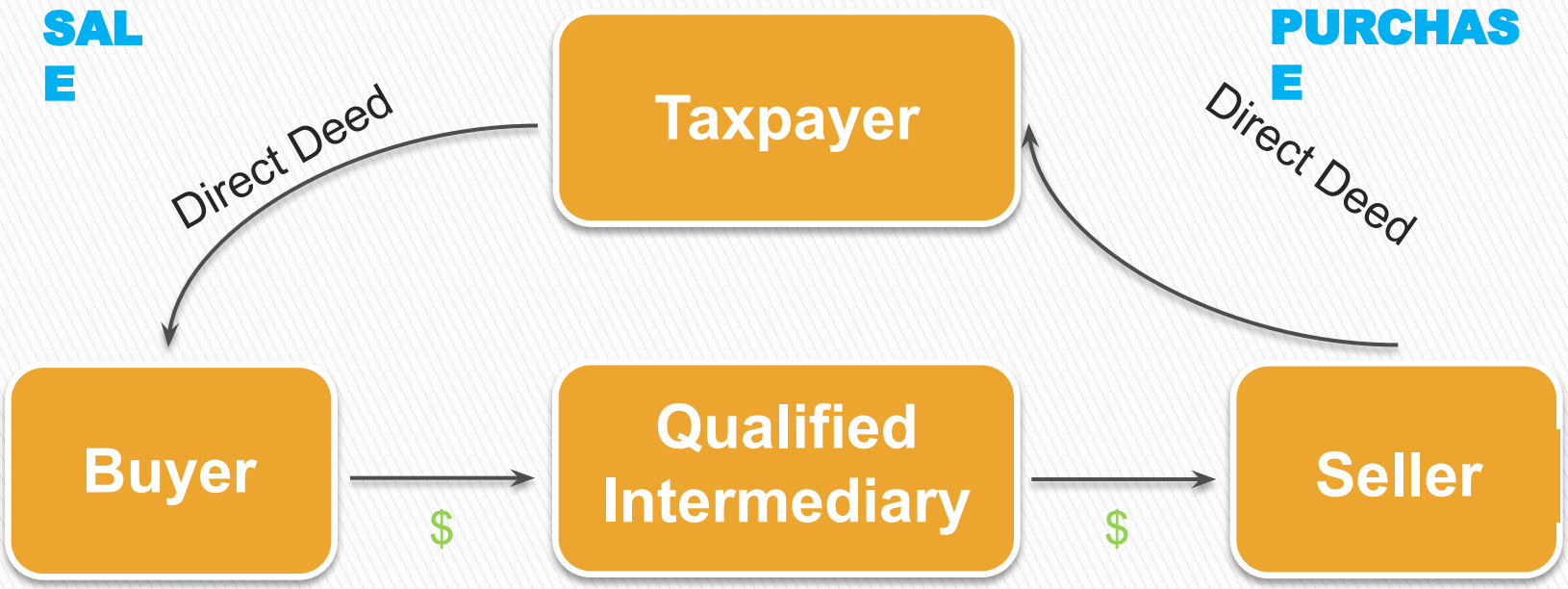
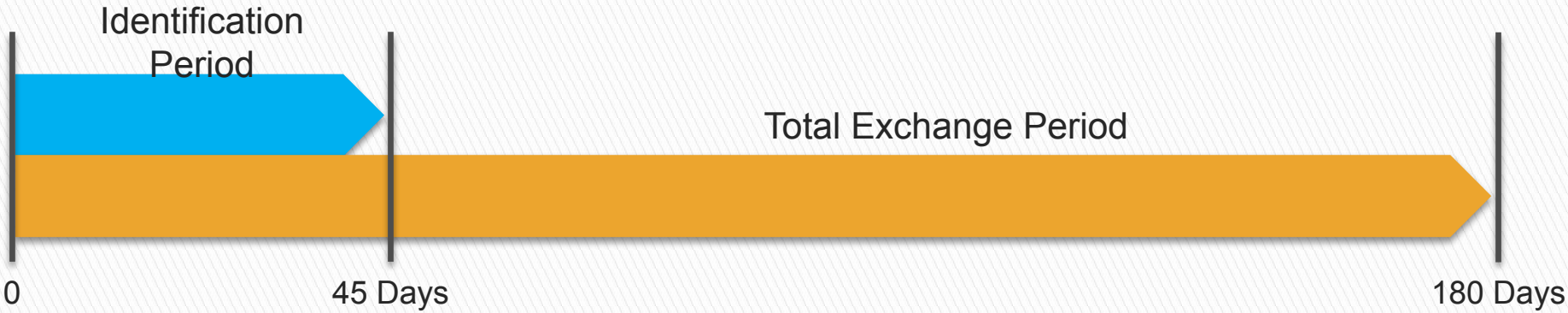
The Delayed Exchange





Identification Rules

- **Three Property Rule:** The taxpayer may identify up to three properties of any fair market value.
- **200% Rule:** The taxpayer may identify an unlimited number of properties provided the total fair market value of all properties identified does not exceed 200% of the fair market value of the relinquished property.
- **95% Rule:** If the taxpayer identifies properties in excess of both of the above rules, then the taxpayer must acquire 95% of the value of all properties identified.

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Identification Rules

Identification must be:

- Made in writing and signed
- Unambiguously describe the property
- Hand delivered, mailed, telecopied or otherwise sent
- Sent by midnight of the 45th day
- Delivered to the Qualified Intermediary or a party related to the exchange who is not a disqualified person

Replacement Property Identification Rules

In accordance with the provisions of IRC Section 1031, the replacement property must be identified in writing on or before midnight of the 45th day from the date the relinquished property is transferred. Please refer to sections 3.1 and 3.2 of the Exchange Agreement for this transaction, which summarizes the IRS requirements for identification of replacement property.

Identified replacement property must be "unambiguously" described by the exchanger by street address, legal description or "distinguishable name".

In the event that the Replacement Property consists of improved real property where the improvements are to be produced during the Exchange Period, then, in addition to the street address, legal description, or "distinguishable name", the identification must include as much detail regarding the construction of the improvements as is practicable at the time the identification is made.

As of June 10, 1991, rules and regulations became effective which dramatically impacted the number of properties that can be identified as potential replacement properties. The rules are as follows:

1. ***3-Property Rule**: A maximum of three properties may be identified without regard to the fair market value of the properties.*

   or

2. ***200-Percent (200%) Rule**: Any number of properties may be identified, so long as the aggregate fair market value of the properties identified does not exceed 200% of the aggregate fair market value of the Relinquished Property.*

   or

3. ***95-Percent (95%) Rule**: The exchanger may identify any number of properties without regard to the aggregate fair market value, so long as exchanger receives 95% of the aggregate fair market value of all identified Replacement Properties prior to the end of the 180 day period.*

In accordance with section (c)(4)(ii)(a) of the IRC Section 1031 Regulations, if you close on replacement property prior to your 45th day, the acquired property will be considered identified property and will count as identified property under the above identification rules.

It is solely the exchanger's responsibility to comply with the rules and regulations regarding the 45-day identification period and 180-day exchange completion period. You must acquire ownership of all replacement properties you intend to purchase, within a maximum of 180 days after the close of the sale of the first relinquished property you sold as part of this exchange. Refer to section 2.4 of the Exchange Agreement stating the restrictions regarding your rights to obtain the benefits of the exchange proceeds once you identify property.

Please notify API immediately when you have selected a closing agent on any Replacement Properties.

This identification letter must be hand delivered, mailed, telecopied, or otherwise sent to our office prior to midnight, sender's time, on the 45th day following the closing of the Relinquished Property.

Attn: _____ API Order No.: _____
Fax #: **(916) 749-1270**
Email: **info@apiexchange.com**

Exchanger: _____

Relinquished Property: _____

Please check the box that indicates the method for identification:

- ☐ **3-Property Rule**: A maximum of three properties may be identified without regard to the fair market value of the properties.
- ☐ **200-Percent (200%) Rule**: Any number of properties may be identified, so long as the aggregate fair market value of the properties identified does not exceed 200% of the sales price of the Relinquished Property(ies).
- ☐ **95-Percent (95%) Rule**: The exchanger may identify any number of properties without regard to the aggregate fair market value, so long as exchanger receives 95% of the aggregate fair market value of all identified Replacement Properties prior to the end of the 180 day period.

	Property Address/Description	% Interest in Property (if less than 100%)	Value (for 200% and 95% Rules)
1.			
2.			
3.			
4.			
5.			
6.			

Aggregate Fair Market Value: $ _____

If more than 6 properties are to be identified, please add a separate page.

Exchanger:

_____ **Dated:** _____

Receipt on _____ acknowledged by:

API: _____

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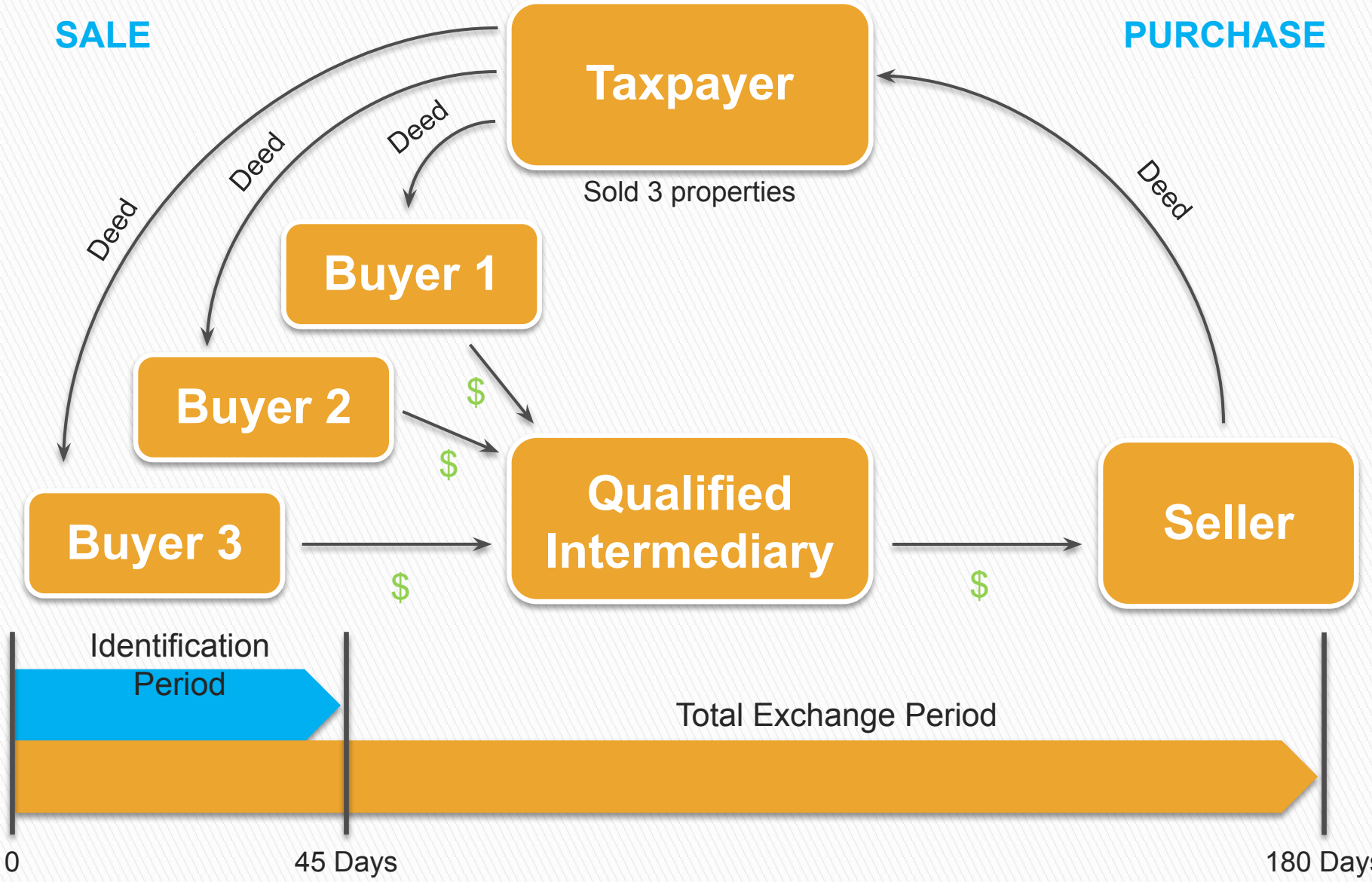
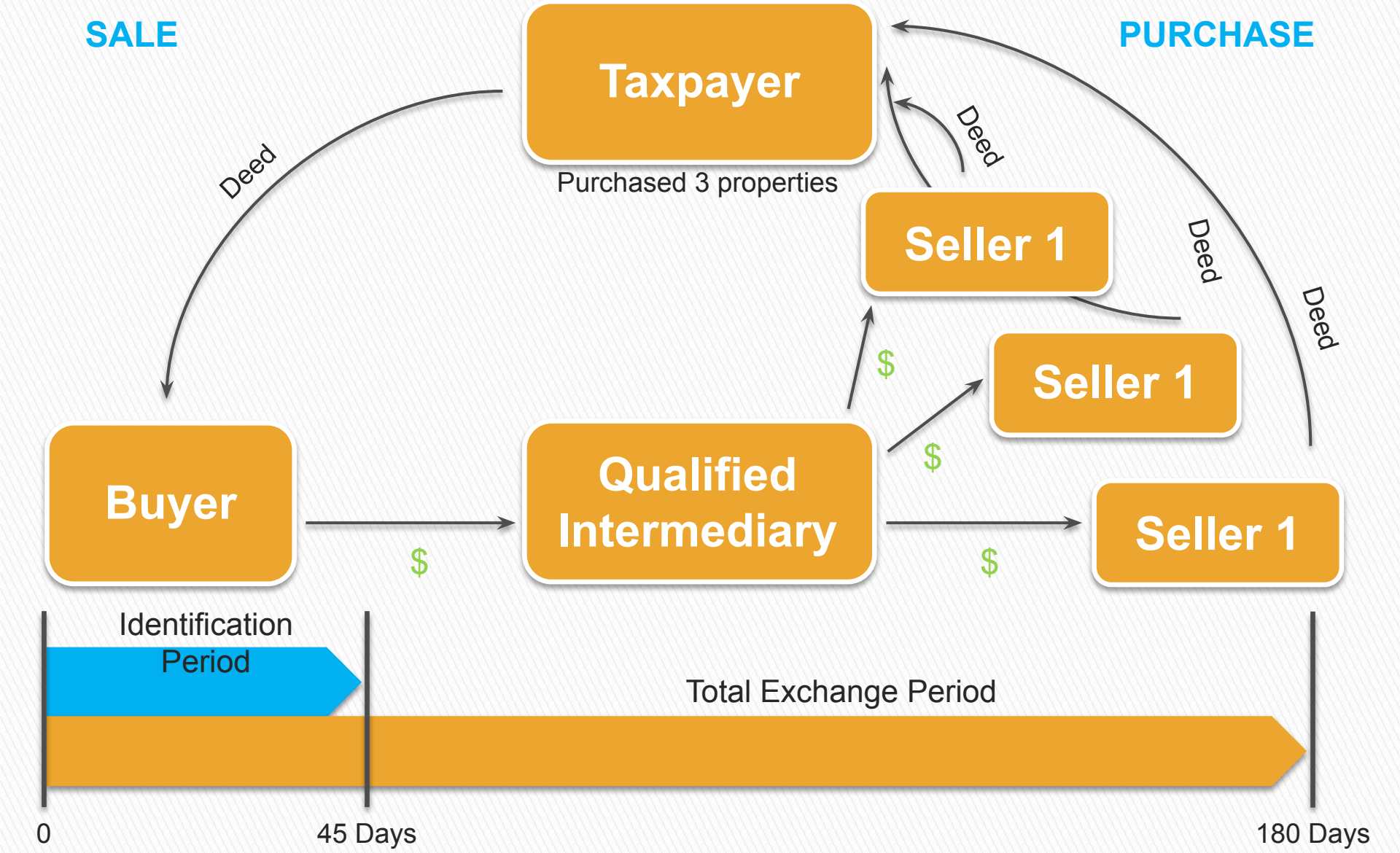
Multiple Property Exchange

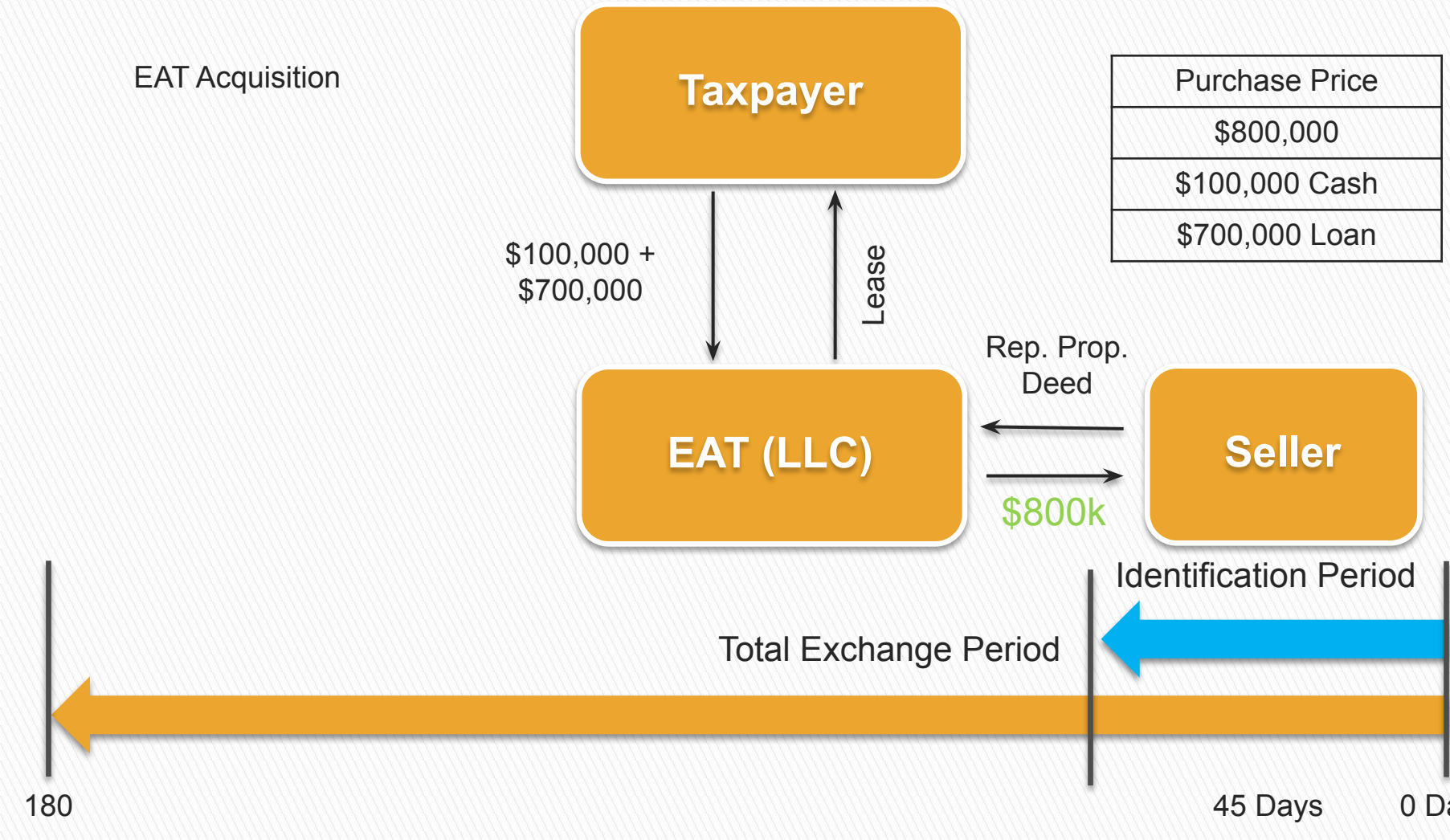


Multiple Property Exchange



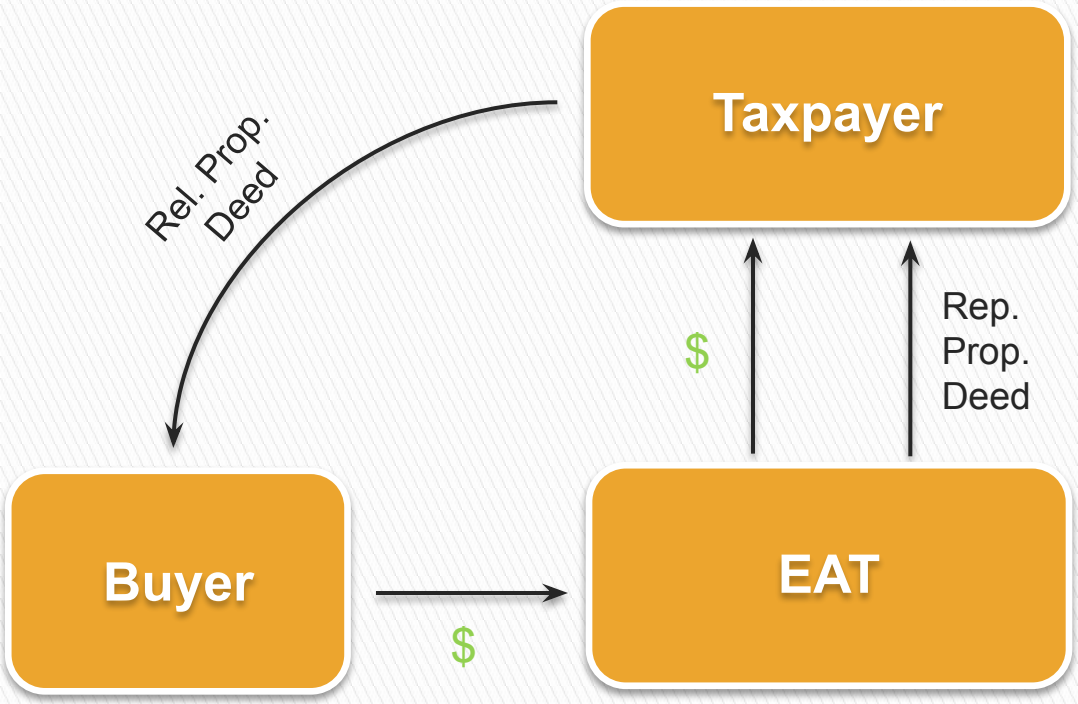
Reverse Exchange Format

Replacement Property Parked - Step 1



Reverse Exchange Format

Replacement Property Parked Sale of RQ- Step 2



	Sale Price	Purchase Price
Value	$400,000	$800,000
Debt	$200,000	$700,000
Equity	$200,000	$100,000

Grow Real Estate Portfolio

- **Purchase Year**
- Purchase: $500K
- Down: $100K (20%)

- **Year 8**
- Value: $750K
- Loan: ~$350K
- Equity: ≈ $400K

- **Sell + do a 1031**

- Roll $400K into:
  - More units, more income, more appreciation

- That's how portfolios grow *fast*

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Closing Issues with Exchanges

Can a 1031 Exchange be Set Up at the Last Minute?

- Yes!
- As long as the transaction has not closed
- If the burdens and benefits of ownership have not transferred from the seller to the buyer, a 1031 exchange can be set up at the last minute or at closing table.

What Needs to be Done to Set Up a Last Minute Exchange?

- Stop the closing
- Promptly contact a Qualified Intermediary and explain you have a transaction closing right now and you need 1031 exchange documents prepared and forwarded immediately.
- Once the 1031 exchange documents arrive, have the seller and buyer sign the appropriate 1031 exchange documents.

The API Advantage

- **Experience -** Since 1990, Asset Preservation, Inc. (API) has been a leading national Qualified Intermediary and has successfully completed over 300,000 tax-deferred exchanges.
- **Expertise –** API's Senior Exchange Counselors provide responsive service and attention to every exchange transaction. API's Commercial Division handles complex parking arrangement (reverse and improvement) exchanges and multi-site commercial transactions.
- **Security -** API provides unmatched security for the management of exchange funds including the financial strength and backing of Stewart Information Services Corporation (NYSE: STC) under a written "Letter of Assurance" provided on request. API management maintains tight financial controls and multi-layered security systems necessary to provide a level of comfort and the quality of performance relied on by sophisticated investors and Corporate America.

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Twitter twitter.com/1031taxexchange

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Add me to your contacts!

Stephanie Kelsey cell 310.508.7367

Stephanie@apiexchange.com

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Contact Asset Preservation

So Cal – Stephanie Kelsey	310.508.7367
HEADQUARTERS – California	800.282.1031
EASTERN OFFICE – New York	866.394.1031
WEBSITE	apiexchange.com
EMAIL	Stephanie@apiexchange.com

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Question and Answers

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