What Is a 1031 Exchange?

1031 exchanges are specifically structured transactions that join together the sale of an old property and the purchase of a new property for the purpose of deferring taxes.

Exchanges are primarily used for buying and selling investment real estate, but they can also be used for personal property that is used in a business. Examples of qualifying property include mineral interests, bare land, rental property, commercial buildings and homes other than your primary residence.

What Is an Improvement Exchange?

An improvement exchange allows you to sell your old property and use that money to buy a property that needs a lot of work with part of your funds, and to use the remainder of your funds to fix it up. There are a few critical things that you need to know:

You Must Equalize Your Exchange.

The first critical rule is that you only have 180 days from the closing of your old exchange to equalize your exchange.

For example, you sell your old property for $250,000 and you are thinking of buying a property that needs a lot of work. The cost of the building is $175,000 and it needs about $150,000 of repairs. The total project will run you about $325,000. By the 180th day, you need to have at least $250,000 invested in the new project (both land and improvements) to equalize your exchange.

What Happens if You Don’t Meet Your Equalization Target?

If you don’t meet your equalization target ($250,000 in our example), you pay tax on the amount that you fall short. Using our example, if you are only able to complete $50,000 of the improvements by the end of your 180 days, you would pay tax on the difference of $25,000, since the purchase of the property for $175,000 and the $50,000 of improvements only totals $225,000. As is true with 1031 exchanges in general, the gain comes first, which means that the entire $25,000 is taxable - you get no offset for your investment in the old property.
Once You Take Title to the Property, Your Exchange is Over.

When you take title to the property, your exchange is over, at least on that property. For this reason, you need someone, other than yourself, to take title to the land and do the construction.

Many times our clients will want a close friend or business associate to take title to the property for them. Be careful with this since a recent court case disallowed an exchange that did this.

For this reason, most of our clients choose to have us take title to the property. The title will be in the name of a limited liability company (an “LLC”) that we will set up for just this purpose. The money for the purchase of the property and for payment of the improvement costs can come from your exchange account that we are holding. Of course, you still pick the contractors, you pick the colors, you pick the carpet, etc.; we just pay the bills. The LLC will continue to hold the property until you complete your improvements, or until you run out of time on your 180 day limit.

How Do You Identify the Improvements on Your 45 Day Letter?

Since you will be taking title to the improved building to complete your exchange, you need to identify this as such on your 45 Day Identification Form. In most cases your identification will read something like this: “Purchase of the 6 unit apartment building at 123 Main Street, Denver, CO, for $175,000 with the following improvements: exterior painting - $25,000; interior painting - $15,000; new kitchen cabinets in units 1, 4 &...you pick the contractors, you pick the colors, you pick the carpet, etc.; we just pay the bills...”

The IRS Rules for Exchanges...

You will need to follow six primary rules for your exchange to meet stringent IRS regulations:

1. **Real Property Use.** Both your old and new properties must qualify as investment or business use. If both properties pass this test, you can exchange nearly any type of real estate.

2. **45 Day Identification Period.** You have 45 days from the closing of your sale to list the properties you may want to buy. There are no exceptions to the deadline.

3. **180 Day Exchange Period.** From the sale closing date, you have 180 days to close on the purchase of one or more properties from the 45-day list. Again, there are no exceptions to this.

4. **Qualified Intermediary (QI).** The IRS mandates that you use a QI to prepare the legal documents for your exchange. Because the QI must be independent, it cannot be your friend, employee, broker, or even your accountant or attorney. The QI also holds your money, so that you do not have access to it.

5. **Proper title holding.** You must purchase and take title to your new property exactly as you held title to your old property.

6. **Reinvestment Requirement.** To defer all of your capital gain tax, you must buy a property equal or higher in value than the one you sold. Also, you must reinvest all of the cash proceeds from your sale.

The regulations, court cases, and IRS rulings that apply to your exchange are ever-changing. It is important to choose a QI like The 1031 Exchange Experts that understands these laws, and carefully monitors new legal developments.
5 - $15,000; replace carpet in hallways
- $5,000, replace carpet in units 1, 4
& 6 - $10,000; and repairs to the roof
- $5,000, for a project total of $250,000.”

**The Improvements Must Be Completed to Count.**

For the improvement costs to count towards your 1031 exchange, they must be completed. This means that you only want to include improvements that can be completed before the end of the 180 days. Don’t include landscaping as an improvement for example, if your property is going to be covered with snow during much of the 180 days. And only include enough improvements to equalize your exchange. In our example, even though you are planning $150,000 of improvements, you only want to identify $75,000 of these since that is all that you require to equalize your exchange.

**The Improvements Must be Completed Before We Can Transfer the Property to You.**

Not only must the improvements be completed to count towards your exchange, they must be completed before we can transfer the property to you. For this reason, we suggest that you choose the improvements for your identification list carefully. It is best to use the largest, easiest to complete improvements on your list.

**How Is The Improvement Contract Handled?**

If we are taking title to the property, the contracts you negotiate with the contractors for the repairs should be in the name of the LLC that we set up to take title to the property. You should add a clause to these contracts that allows you to assume them. In this way, the contract will stay in force even after the LLC transfers ownership of the property to you in case there are disputes concerning how some of the contracts are completed.

**How Do The Bills Get Paid For The Improvements?**

As construction or installation of the improvements progresses, there will be a need for periodic payments. Each of the contractors on the job will submit periodic bills to you for payment. After you approve each bill in writing, please fax it to our office for immediate payment. Funds for the payment of bill will be withdrawn from your exchange account and forwarded to the contractor. These payments will include a “lien waiver” statement. We will not pay any bills until they have been approved by you first.

**Can You Do Some of the Construction Work Your Self?**

Yes, you may - but there is a problem with paying you for that work. One of the requirements for a proper exchange is that you may not touch the money in between the sale of your old property and the purchase of your new. Therefore, if you, Fred Jones, do the work, we can not write a check from the exchange account to Fred Jones for construction. On the other hand, if you own Jones Construction Company, we can write a check to the construction company for work it does.

**What Happens if There Is a Improvement Loan?**

Improvement financing can be a problem. Quite often improvement lenders will advance the funds for all of the improvements in a lump sum. Since we will hold title until the improvements are completed, you probably will end up dealing with a “portfolio lender” - in other words, a bank. You might have to get a “bridge loan.”
What Makes a ExpertExchange Different?

What many QIs don’t want you to know is that their industry is largely unregulated. Without standards, they can offer you little assurance of their training and qualifications. In fact, they will do little more in an exchange than fill in the blanks on generic forms.

But The 1031 Exchange Experts are different: we do ExpertExchanges. All of our exchanges are handled by a team of CPAs and real estate attorneys. Choosing our licensed professionals ensures that the education, knowledge and ethical standards of our team have passed rigorous testing.

You can trust our experience as well. We’ve completed thousands of qualified 1031 exchanges.

Don’t just take our word for it. Our experts are published in trade journals across the country and cited in national publications like Forbes and Bloomberg’s Wealth Advisor. So that’s why we say The 1031 Exchange Experts are writing the book on 1031 exchanges.

What Can I Expect with a ExpertExchange?

When you choose The 1031 Exchange Experts, you’ll have reliable service before, during and even after your exchange. Our expert consultants are available seven days a week, virtually around the clock, to answer your questions as they arise.

How Can I Get Started?

All it takes is a phone call or e-mail, and The 1031 Exchange Experts will go to work for you. We are ready to provide further information and answer any of your questions.

Find Out More About Our Services:

Nation-Wide
Toll free: 866-694-0204

Visit us at: www.expert1031.com

Here’s How a ExpertExchange Works:

• Our experts consult with you on how to best structure your exchange – always considering your particular situation.

• We meticulously document your exchange to meet all IRS requirements.

• We coordinate with your realtor, attorney, CPA and closing agent to properly complete the exchange.

• We keep everyone informed at critical points throughout the process with our exclusive 1031TouchPoints program.