TEXAS ESCROW®

# 1031 EXCHANGE

**If you have real property for sale, which is used in your trade or business, or is held for investment, you may be eligible to defer the capital gains tax when the property is sold by utilizing a deferred 1031 Exchange. In order to receive this tax treatment, you should contact a Qualified Intermediary, like Texas Escrow Company, a subsidiary of Republic Title of Texas, Inc., and complete the documentation necessary to create your exchange <u>before</u> you close the sale of your property.**

The property sold needs to be real estate that you have held for investment or used in your trade or business, such as an office building or rent house. Vacation homes for your personal use, or your personal residence, do not qualify for this tax treatment.

You should consult your accountant or attorney for advice on the utilization of a 1031 Exchange, especially if your accountant files your income tax return. It is important that the person filing your income tax return agrees that the exchange achieves the tax deferral you want. Your accountant can also estimate the tax payable on your sale so you can evaluate whether you want to do a 1031 Exchange.

The 1031 Exchange only *defers* the capital gains tax (long or short term) on the sale of real property by purchasing replacement real property of an equal or greater value than the property sold.

Using exchange funds to purchase like-kind replacement real property for an investment, or use in your trade or business, and then later selling that replacement property in another 1031 Exchange to purchase other replacement property, will continue to defer the capital gains tax, plus any additional gain that might accrue by virtue of an increased value of the replacement property. In many cases, once you start exchanging real property, you need to continue using 1031 Exchanges to purchase real property if you wish to continue deferring the capital gains tax. When you sell the replacement property without using a 1031 Exchange, capital gains taxes will be due.

We suggest that you review the supplemental Definitions and Rules of a Deferred 1031 Exchange which is written in easy to understand language to familiarize yourself with some of the terms and rules, that are involved in a 1031 Exchange.

All the definitions and rules of a deferred 1031 Exchange should be discussed with your tax advisor, accountant, attorney and a Qualified Intermediary before you do any exchange transaction. The rules encompass all kinds of situations and we repeat that it is imperative to consult with your tax advisors and a Qualified Intermediary about the transaction you have in mind before you sell and, in some cases, before you even contract to sell.

*Texas Escrow Company is an experienced Qualified Intermediary and ready to be of assistance.*

**Texas Escrow Company**
**A Qualified 1031 Exchange Intermediary**
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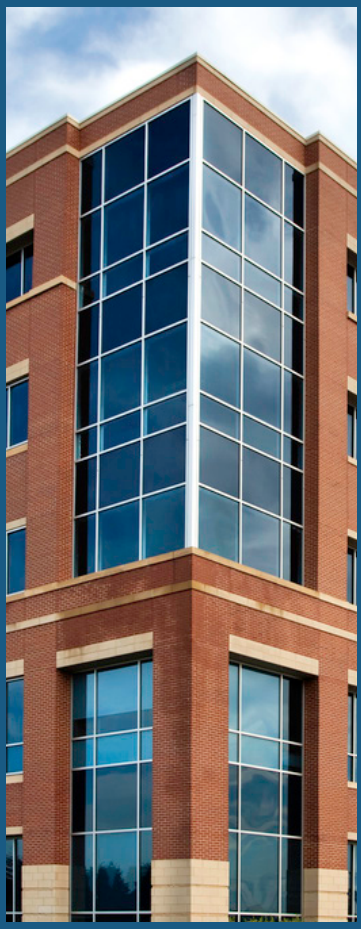
# DEFINITIONS & RULES OF A DEFERRED 1031 EXCHANGE



**1031 Exchange**

An event where a taxpayer exchanges or trades real property held for investment or used in a trade or business for other real property and defers the capital gains tax on the transaction.

**Tax Deferred**

The capital gains tax which would have been paid on the sale of the real property is not paid but is deferred to be paid at a later time when the property traded for is sold in a non-exchange sale.

**Property Held for use in a Trade or Business**

Any real property used by a taxpayer in its business. This could be an office building, warehouse, ranch, shop, garage, farm, etc.

**Investment Property**

This is real estate purchased to produce an investment income or an investment gain on resale. It can include, but is not limited to apartments, a rent house or raw land.

**Like-Kind Property**

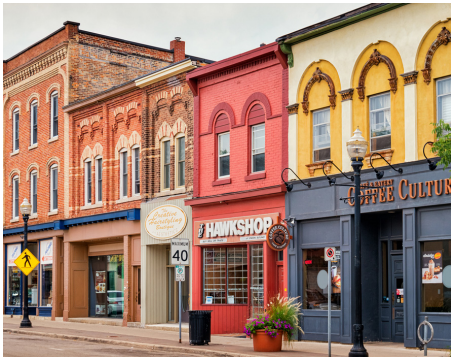
In the exchange world, "like-kind" does NOT mean you must exchange an apartment project (investment property) for another apartment project, or raw land for raw land, it means that you must exchange real estate for real estate. This permits, within the categories of "held for investment" or "used in your trade or business", the exchange of apartments for land, or office buildings for apartments, etc., as long as the old properties sold and the new properties acquired are either held for investment or used in a trade of business. The property sold and the property acquired do not have to be exactly alike, they just have to be real estate and fall in the category of "held for investment" or "used in your trade or business".

**Relinquished Property:**

Relinquished Property is the real estate held for investment or use in your trade or business which is sold or "relinquished". Think of the Relinquished Property as the property being sold and the Replacement Property as the real property being acquired.

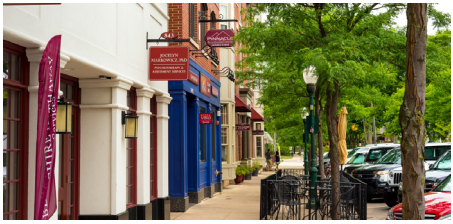
**Replacement Property:**

Replacement Property is the real estate acquired by the taxpayer/seller in a 1031 exchange as replacement for the relinquished property.




**Exchange Proceeds**

The cash received by the Qualified Intermediary through the sale by the taxpayer of the Relinquished Property and any debt paid on the property sold. In order to defer all of the tax on a sale you must spend all of the cash proceeds received or more if you want to and you must borrow the same amount of money or more if you need or want to that was used to pay off any loan or loans on the property sold. You will pay the tax on any cash proceeds not used to buy Replacement Property or any loan paid off in your sale that was not replaced with same or greater payoff amount of loan on the Replacement property.



**The 45-Day Rule**

You must identify by written notice (signed by you) to your Qualified Intermediary the Replacement Property or Properties (you can identify more than one possible Replacement Property) you want to buy <u>within 45 days after you close the Relinquished Property.</u> Do <u>not</u> count the date of closing; count 45 days after the closing date and that is the end of the "Designation or Identification Period" – the true end, whether it's a Saturday, Sunday or <u>any</u> legal holiday. Better get this part completed on that date as a minimum. Before that date is better. After that date, your exchange may be disqualified.

### The 180 Day Rule

You must close, fund, and acquire (do it all) the Replacement Properties within 180 days after you close the Relinquished Property. Do not count the date of closing; count 180 days after the closing and that's the "drop-dead" date to completely acquire the Replacement Property – the true end, whether it's a Saturday, Sunday or any legal holiday. Better complete this part on this day as a minimum. Before that date is better. After that date, your exchange may be disqualified.

### Three Property Rule

Try to designate three Replacement Properties or less to purchase, generally, because if you stay with three or less, you don't have to worry with anything other than being sure it is like-kind property. If you designate four or more, then you must deal with the "200% Rule".

### The 200% Rule

This rule only comes into play if you designate more than three properties as possible Replacement Properties. If you do, add up the "fair market values" of all the properties designated and be sure that this aggregate number is not more than the gross sales price of the Relinquished Properties times 2. If it is more and you don't fall within the "95% Rule", your exchange is outside the safe harbor and may fail.

### The 95% Rule

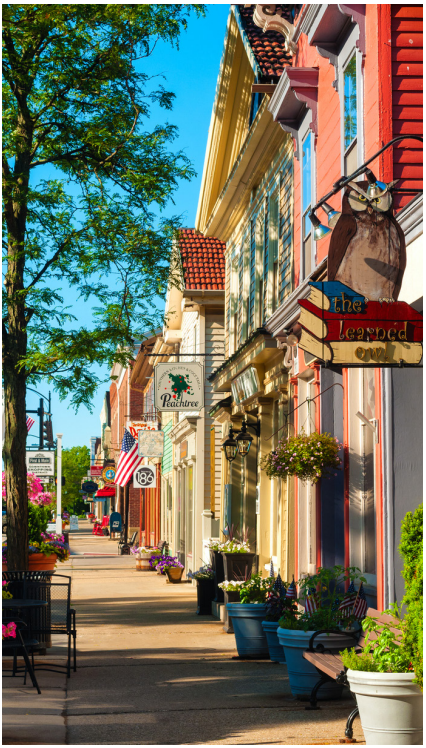
This is an exception to the consequences of violating the 200% Rule, which applies if you violate the "Three Property Rule". If your sum of the fair market values of more than three Replacement Properties is greater than two times your sales price of the Relinquished Property, you are still "safe" if you acquire 95% in value of these designated properties, which means that you really need to buy all of the Replacement Properties you designated.

**Exception to the 180 Day Rule**

You don't get 180 days to complete the exchange if you have to file your Federal income tax return for the year in which your relinquished property sold before the 180th day. If your tax return for the year in which your relinquished property sold is due on April 15th and your 180th day falls in May, you have to complete your acquisition of the replacement property before April 15th even if there are more days left in the 180 day time frame. BUT, if you file an extension to your tax return, then this exception doesn't apply. Remember to file the extension if you are in this situation.

**Direct Deeding**

1031 Exchange allow Direct Deeding, making it all much simpler. In previous years, the exchange taxpayer deeded the property to be sold to the Qualified Intermediary who would then deed to the buyer of the Relinquished Property, and the seller of the Replacement Property would deed to the Qualified Intermediary who would deed to the exchange taxpayer. You don't have to do this anymore. You can deed the Relinquished Property directly to your buyer, and receive the Replacement Property deed direct from the seller.




*Disclaimer:*

**This information is a summary of some of the common terms involved with 1031 deferred tax exchanges. Do not rely on this summary alone to make an exchange decision, or think that there isn't much more involved than what is described in these simple definitions. Exchange decisions should be based on conversations with a tax advisor, an accountant, a Qualified Intermediary, and a tax attorney.**

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