Metropolitan Title Exchange Company

America's Premier Independent Title Agency

Metropolitan Title Company provides you with "one stop shopping" for all your real estate transactions. Whether you need a title search, title insurance, someone to conduct your professional real estate closing, or a tax deferred exchange, we assure quick, easy, and convenient service to all our customers. Metropolitan Title Exchange Company promises professional services and competitive prices.

We hope that this brochure will help you understand the benefits of a tax deferred exchange program.

General Statutory Requirements of Section 1031

Internal Revenue Code (IRC) Section 1031 permits property owners to exchange one property for another property without incurring income tax on the gain realized on the original property.

There are a number of rules that restrict the types of real estate transactions that can qualify for a tax deferred exchange. The general statutory requirements are as follows:

- Both the property surrendered and the property received in the exchange must be held either for productive use in a trade or business, or for investment.
- The property surrendered and the property received must be of "Like Kind".
- The exchange must be a reciprocal transfer of properties as distinguished from a sale and repurchase, although the exchanges need not be simultaneous.
- The property surrendered must not be property held primarily for sale or certain other excluded property.

Background

A tax deferred exchange can be an important tax planning strategy for an individual who owns investment real estate. Authorized by Section 1031 of the IRC, it is a method by which a property owner exchanges one property for another to avoid paying federal income taxes on the transaction.

In a typical real estate sale, the property owner is taxed on any gain realized by the sale of the property. In a tax deferred exchange, however, the tax on the transaction is *deferred* until some time in the future, usually when the newly acquired property is sold. Because the exchange itself is not taxed, it is often referred to as a "tax free exchange". The transaction permits a property owner to dispose of one property and acquire another. The transaction must be structured in such a way that it is conducted as an exchange of one property for another, rather than the sale of one property and the purchase of another. This is often achieved by converting a sale and a reinvestment in a replacement property into an exchange by means of an exchange agreement and the services of a qualified intermediary, who ensures that the exchange is structured properly.

Structure of an Exchange

In a typical sales transaction, an individual sells property for cash. He can use a portion of the cash acquired in the transaction to pay tax on the gain. The net proceeds can then be reinvested in another investment. However, if someone exchanges real property for more real property, he does not receive cash from the transaction. The investor, in an exchange, has no cash with which to pay tax.

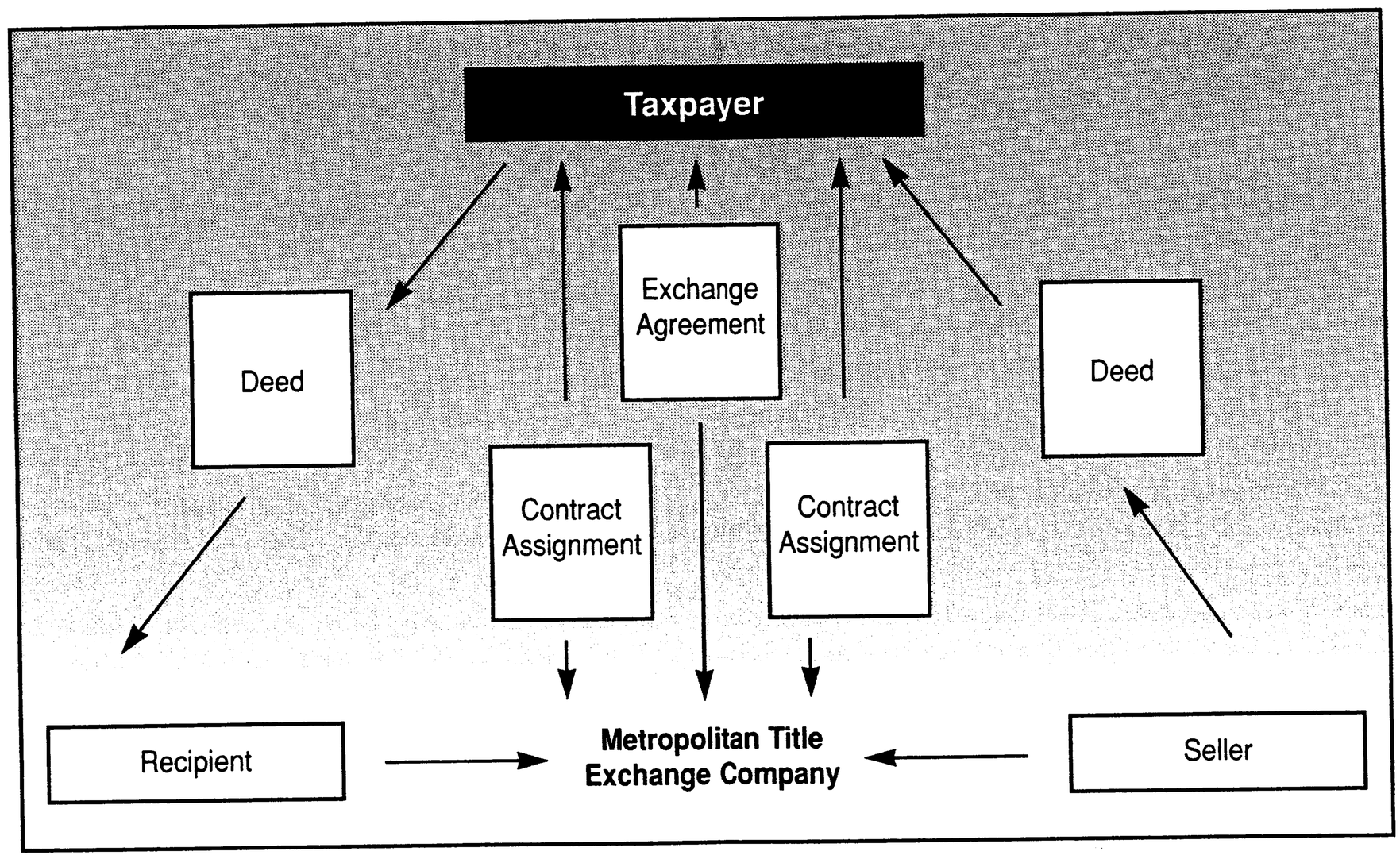
By permitting a tax deferral, Congress has given taxpayers the ability to move from one investment directly into another without having to liquidate other investments, or settle for less valuable property.

There are up to four parties involved in a tax deferred exchange:

the taxpayer, the seller, the buyer, and the intermediary. The taxpayer is the only one who will receive tax deferral benefits from the exchange.

- The taxpayer (also referred to as the exchangor) has property and would like to exchange it for new property and receive tax deferral benefits under IRC Section 1031.
- The seller is the person who owns the replacement property that the taxpayer wants to acquire in the exchange.
- The buyer is the person with cash who wants to acquire the taxpayer's property.
- The intermediary buys and then resells the properties in return for a fee. Very few CPAs act as intermediaries because there must be a two year period between the time a CPA was the client's accountant and when the CPA acted as an intermediary. Similarly, a taxpayer's attorney, employee, or real estate broker also is considered to be "related" to the taxpayer and thus cannot act as an intermediary for an exchange transaction.

The party who will end up with the taxpayer's relinquished property is not necessarily the same party who owned the property that the taxpayer will eventually own. Relinquished property is the real property originally owned by the taxpayer and which the taxpayer would like to dispose of in the exchange. The replacement property is the new property that the taxpayer would like to acquire in the exchange. The typical exchange does not involve the trade or swap of properties between two individuals. Although there will be tax consequences to everyone involved in the transaction it is also important to restate that there is only one taxpayer/exchangor who will receive benefits from a 1031 exchange.



Limitations

In order for an exchange to be completely tax deferred, the replacement property must meet two criteria:

- The replacement property must have a fair market value greater than the relinquished property.
- All of the taxpayer's equity or more must be used in acquiring replacement property. This is referred to as trading up in value and up in equity.

An exchange can still defer tax if the taxpayer receives money or other property (referred to as "boot") in a like-kind exchange, but gain is recognized to the extent of the money and the fair market value of the other amount received. Other limitations also apply to exchanges. For example, although title on the exchanged properties does not have to pass simultaneously, the closing on the replacement property must occur within 180 days of the closing on the relinquished property. This type of exchange is referred to as a tax delayed exchange.

Section 1031 also contains a "like-kind" requirement. Although property must be exchanged for "like-kind" property, the limitation simply means that real property must be exchanged for real property. The kind of real estate that can be exchanged within Section 1031 is extremely broad. Not every exchange of real property interests, however, meets the like-kind requirement. In addition, real property may not be exchanged for personal property.

Types of Exchanges

There are several ways to structure a tax deferred exchange. They may involve two, three, or all four parties and be very simple or quite complex in nature. One of the primary benefits under the tax law permitting the deferred exchange is the ability to close the transaction in stages. In the cases where the relinquished property is transferred to the buyer and the taxpayer does not know what property he wants to acquire, a delayed exchange is necessary. Because the replacement property is not known at the time that the relinquished property is transferred to the buyer, the two portions of the transfer must take place at different times. This is referred to as a "Delayed Exchange with Intermediary".

In a delayed exchange, the taxpayer has 45 days to identify the property he wants as the replacement property. After identifying the property, the transfer of the replacement property must close within 180 days of the transfer of the relinquished property.

Qualified Property

In general, all property, both real and personal, can qualify for tax deferred treatment. Some types of property, however, are specifically disqualified. These include stock in trade or other property held primarily for sale, stock, bonds, or notes, other securities or evidences of indebtedness or interest, interest in a partnership, certificates of trust or beneficial interest, and interests in law suits. In most instances, tax deferred exchanges are conducted with real property.

The Purpose Requirement

Not every type of real property is eligible for tax deferred treatment. Section 1031 indicates that "no gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like-kind which is to be held either for productive use in a trade or business for investment." This simply means that to qualify for tax deferred treatment, the taxpayer's property must be held for productive use in a trade or business or for investment. Additionally, the taxpayer must acquire property that he intends to hold for productive use in a trade or business or for investment.

Generally, any real property other than a principal residence or dealer property (property acquired for resale) qualifies.

The Like-Kind Requirement

Replacement property and relinquished property in an exchange must be like-kind. By definition, this means that the property must be similar in nature or character. One property may be

exchanged for more than one property. Real property is not like-kind to personal property. Again, the kind of real estate that can be exchanged within Section 1031 is extremely broad.

The Holding Period

A proposed amendment to Section 1031 that would have required both the relinquished property and the replacement property to be held for at least one year failed to pass. Nevertheless, the one year period is generally considered to be the minimum holding period for a taxpayer desiring a tax deferred exchange because of the possibility that property held for a shorter period could be construed to have been acquired solely for resale and therefore considered dealer property, which is disqualified for tax deferred exchange treatment. Therefore, property held for less than one year is not generally a good candidate for tax deferred exchange treatment unless circumstances are changed.

The Exchange Requirement

Section 1031 specifically requires that an exchange occur. This simply means that one property must be exchanged for another property, rather than sold for cash. The exchange is what distinguishes a Section 1031 tax deferred transaction from a sale and purchase. To ensure that the exchange requirement of Section 1031 is met, deferred exchanges are often accomplished through intermediaries.

Time Limits

There are time limits for non-simultaneous (delayed) exchanges. In those transactions in which the taxpayer will acquire the replacement property after the transfer of the relinquished property, there are two time limits established. First, the taxpayer is required to identify the target property within 45 days after transfer of the relinquished property **and** the taxpayer must close on the replacement property before the earlier of 180 days after the transfer of the relinquished property or the due date of the taxpayer's federal income tax return for the year in which the relinquished property is transferred.

Alternative and Multiple Properties in Delayed Exchanges

With regard to delayed exchanges, whether one property or more than one property is transferred by the taxpayer as part of one exchange, the number of replacement properties that may be acquired is up to three properties, without regard to their fair market value or more than three, if the total fair market value of all of 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.

Tax Consequences of Exchanges

In order to understand the tax deferral, which is obtained in a Section 1031 exchange, it is necessary to understand several terms and definitions.

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.

Adjusted Basis

The next step in determining the specific tax consequences in an exchange is to establish the adjusted basis of the relinquished property. Calculating the adjusted basis is simply a matter of beginning with the basis (the cost of the property) and adding the cost of any capital improvements made to the property during the taxpayer's ownership, and subtracting any depreciation taken on the property during the same time period.

Even if a taxpayer's adjusted basis in a property is greater than his 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" is the difference between the total consideration (cash and anything else of value) received for a property and the adjusted basis.
- "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 which it is realized.

In an exchange that qualifies under Section 1031, realized gain is recognized to the extent that "boot" is received. In an exchange of real property, any consideration received other than real property is boot. The amount of gain recognized is always limited to the gain realized or boot, whichever is the smaller amount. Therefore, for a transaction to result in complete non-recognition of gain, the taxpayer must receive like-kind property with an equal or greater market value and debt than the property exchanged, and receive no boot.

Boot

In an exchange of real property, any consideration received other than real property is boot. There are two types of boot.

- Cash boot is cash or anything else of value received.
- Mortgage boot is any liabilities assumed or taken subject to in the exchange.

Boot Netting Rules

- Cash paid on the acquisition of replacement property offsets cash received on the disposition of relinquished property.
- Cash paid on the acquisition of replacement property offsets debt relief on the disposition of relinquished property.
- Debt assumed on the acquisition of replacement property offsets debt relief on the disposition of relinquished property.
- Debt assumed on the acquisition of replacement property will not offset cash received on the disposition of relinquished property.

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.

Constructive Receipt

If the taxpayer actually receives the proceeds from the disposition of the relinquished property, the transaction will be treated as a sale and not as a tax deferred exchange. Even if the taxpayer does not actually receive the proceeds from the disposition of the property, the exchange will be disallowed if the taxpayer is considered to have constructively received them. The income tax regulations state that income, even if it is not actually reduced to the taxpayer's possession, is constructively received by the taxpayer if it is credited to his or her account, set apart for him, or otherwise made available so that he may draw upon it at any time.

It is therefore critical that in every non-simultaneous exchange, receipt of any consideration other than like-kind property upon disposition of the relinquished property is substantially limited or restricted. Although there are a variety of safeguards available to a taxpayer, the use of a qualified intermediary is the principal means by which to ensure a taxpayer does not actually or constructively receive the proceeds.

For more information about
Metropolitan Title Exchange Company
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