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I R S Q U A L I F I E D I N T E R M E D I A R Y

Strategies for Real Estate Investors

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IRS 1031 Tax-Free Exchange Guide

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Table of Contents

<hr/>		<hr/>	
C H A P T E R 1 : 1		200% rule and the 95% exception 17	
Introduction - the secret of 1031	1	The 180-day rule	18
The tax-deferred advantage	2	Related party sales	18
How to comply with Section 1031	3	Boot	19
Making money with 1031	4	More tools for the investor	20
<hr/>		<hr/>	
C H A P T E R 2 : 6		C H A P T E R 4 : 21	
Introduction to real estate taxes	6	Lesser known investment opportunities	21
Capital gains tax	7	Cost Segregation Analysis	21
Tax Basis	8	Ways to make money in real estate...	22
Depreciation	9	TIC - Tenant in Common	23
Recapture of Depreciation	9	Zero Cash Flow properties	23
Loss Carryovers	9	Putting it all together	24
Disallowed capital losses	10	<hr/>	
Installment sales	10	C H A P T E R 5 : 25	
Sale of primary residence	11	Some solutions for investors	25
The 1031 exchange	11	The IRS wake-up call	25
<hr/>		Now let's swing for the fences	27
C H A P T E R 3 : 12		About the author:	28
Introduction to 1031 exchanges	12	<hr/>	
Types of 1031 exchanges	13		
Delayed exchange	13		
What property "qualifies" under 1031?	14		
Tax returns	16		
Your qualified intermediary	16		
"Safe harbor" rule - waiting period	16		
The 45-day rule	17		
3-Property ID rule	17		

Chapter 1:

Introduction – the secret of 1031

Like betting with the house's money and no tax due on the winnings...

The "best-kept secret of the IRS" – the 1031 like-kind exchange.

Pop quiz for real estate investors (true or false):

You generally prefer to make money rather than to lose money.

You would rather not risk your own efforts and capital unless necessary.

You wish you could pay no tax on investment gains.

If there were a way you could discover your potential losses that you may not even know about, convert those losses into gains with no tax consequences, by investing the government's money and without risking your own, you would probably want to know about it.

The best-kept secret of the IRS is not really a secret at all but the sad fact is that most folks like you (and your clients) who invest in real estate have no idea that when you sell your property, pay income taxes on the gains then reinvest your own after-tax dollars in other real estate investments, you are missing out on a huge opportunity that the IRS would readily give you. The IRS secret is that you could not only re-invest the government's money (i.e., the dollars you just paid in taxes) but also have a legal opportunity to pay no tax on the gains from

that new investment – like betting with the house's money and not having to pay tax on the winnings. The secret is in plain view, in Internal Revenue Code Section 1031.

Unfortunately when you (or your clients) sell investment real estate and then reinvest the proceeds by buying other real estate investments (which is very often the case) you

Tax-free or tax-deferred?

There still would be tax on the gain when the newly acquired investment property is "sold" but it also could be the subject of another "1031 exchange" and replaced by other investment real estate again and again, the "potential" tax being deferred again and again indefinitely.

tax dollars but you get to keep any gains made on the investment of those tax dollars and you would have to pay tax on those gains. But you are now a savvy real estate investor, who knows all about Section 1031, so you would never sell the property – you would do another 1031 exchange and keep deferring and reinvesting those old and new tax dollars again and again.

will lose the money you must pay in taxes. But if you knew how to better structure your sell-buy transactions under the criteria set forth in that Code Section, your tax on the gain from the sale would be deferred and those tax dollars – the government's money – could be put to work in your new investment to earn you future gains. If you later sell the new investment property then you must pay those originally "deferred"

The tax-deferred advantage

The impact of investing those tax dollars and the tax-deferred earnings they produce in the highly leveraged setting of this real estate investment world can be immense as will be illustrated in the examples we will give you.

Who said?

"The most powerful force in the universe is compound interest"

Who do you think it was who made that profound statement? One might guess that it was some financial guru such as the head of the Federal Reserve Bank. In fact, it was none other than Albert Einstein.

Consider this.

Let's say that you "sell" for \$100,000 a vacant lot that you bought for \$20,000 then reinvest the proceeds in a duplex rental property.

- You would have to pay about \$16,000 in tax on the \$80,000 long-term capital gain.



Tax tip: Wait a minute. You might argue that the tax rate on long term capital gains is a maximum of only 15% and certainly not as much as in the example. But you probably have other income and are subject to State income taxes. We will discuss the tax aspects of real estate investment later in this book but, for this example, you need to consider that the tax impact will be about 20% of the gain.

- Assuming no other expense of the sale or purchase, all of your net proceeds are used to buy an \$84,000 duplex.
- Applying 5% inflation per year, the duplex will be worth \$107,208 in five years.

But on the other hand, had you structured the transfer of the lot and subsequent reinvestment in a duplex under Section 1031:

- There would have been no tax payable and the whole \$100,000 price could have been invested in a better duplex; and...
- The duplex would have appreciated to \$127,628 in the five years – you made and extra \$20,421 using 1031.

The 1031 Advantage (after 5 years) - Take Your Pick



Sell then Buy
Worth \$107,208



1031 Exchange
Worth \$127,628

How to comply with Section 1031

You would certainly want the extra money. But why would the buyer of the vacant lot and the seller of the duplex want to go to "all of the trouble" of structuring their transactions around the provisions of the Internal Revenue Code? Because it is no trouble for them – it's no skin off their noses. In fact, if they knew how easy it is and how much money you will save, they might even try to renegotiate their deals with you.

Simple – contact us, your IRS Qualified Intermediary

We will see to it that your lot buyer and the settlement agent are notified that you are assigning the sale proceeds to us as your IRS Qualified Intermediary (your QI). You sign our simple assignment form. You do your sale of the lot at the title agency the way you would ordinarily do except the net proceeds will go into your QI's exchange account for use in your later purchase of the duplex. The settlement agent will have made the modifications as detailed on our simple closing instructions. Although the QI will be identified on the HUD-1 Settlement Statement. You will be issued a 1099-S indicating to the IRS that you received zero funds from the sale and the forms necessary to designate the replacement property. All would be in compliance with the strict rules of the IRS that will have been thoroughly explained to you.

Within a short time you similarly acquire the duplex. Again we notify the proper parties and issue simple instructions. You attend the closing and the money in your QI's exchange fund is used to pay the seller. Proper forms for you to report the exchange to the IRS will be supplied.

Although the Courthouse records will reflect a simple sale of the lot from you to the buyer and another sale of the duplex from the seller to you, your records will document that the lot was exchanged for the duplex and that you did not touch any of the money. The transactions will qualify under 1031 as a tax-deferred like-kind exchange.

Making money with 1031

Before we show you various ways to make serious money using 1031 techniques – like acquiring a future retirement home for investment use before your tax-free sale of your residence when you retire – you need to be clear how the IRS taxes real estate investments and how Section 1031 operates. What follows is an effort to do that with:

Chapter 2. A brief introduction to real estate taxes and topics like capital gains, tax basis, stepped-up basis on inherited property, depreciation, recapture of depreciation, passive income or loss carryovers, installment sales, and the sale of a qualified primary residence...

Chapter 3. Information on the 1031 exchange such as their non-tax related benefits, what property qualifies, the Qualified Intermediary, the 45/180 day "rules" for identifying/acquiring replacement property and some more technical rules...

Chapter 4. Lesser known investor friendly opportunities like cost segregation analysis, tenant in common (TIC) properties and "zero cash flow" properties...

Chapter 5. Some useful examples/suggestions for maximizing tax savings.

Chapter 2:

Introduction to real estate taxes

The IRS versus the real estate investor

What follows is a brief discussion of a very complex subject. As a full-service IRS Qualified Intermediary we may be competent to advise and educate you as to the tax consequences of real estate ownership but this discussion is not intended as such – we do not give tax advice, we only seek to generally discuss some of the tax issues. What follows is not designed to make you a tax expert but rather to help you speak knowledgeably to your own tax expert. Please consult professional counsel.



Tax tip: Of course the Internal Revenue Code is very complex and by no means can we put into a single chapter everything you need to know about taxes as a real estate investor. So you are probably not surprised when we direct you to seek independent professional tax advice. But there is another reason we cannot give you tax counsel – to do so could "disqualify" us as your Qualified Intermediary and jeopardize the deferral of your income taxes on cases we may handle for you. So we hope to make you knowledgeable but we will not render tax advice to you.

In order to decide whether to pay or defer taxes resulting from the sale of real estate, the extent of the tax liability must be considered. And the potential liability depends not only upon the tax rate but also upon the taxpayer's income bracket. Tax rates vary depending upon the object of the tax. For instance "ordinary income" is generally a high rate of tax as is the tax on recaptured capital gain but "long term capital gain" is given a "preferential" (i.e., lower) tax rate. Additionally there are State and sometimes even "local" taxes to be considered.



The IRS can be your friend. Consider these tax benefits that all can be found in the Internal Revenue Code:

- In the sale of your qualified principal residence huge gains can be absolutely excused from tax – time and again.
- With depreciation you get tax deductions without really spending your dollars.
- Long term capital gains are given preferential tax treatment (a lower than ordinary tax rate).
- In installment sales taxable gains can be deferred.
- When a person dies, his or her "heirs" get the property at a stepped-up tax basis that generally will reduce the taxable gain when it may be later sold.
- In Section 1031 like-kind exchanges taxes can be indefinitely deferred.

Imagine putting these tax advantages to work for you...

Capital gains tax

Money received in a sale beyond your cost of the property and expenses of the sale constitutes the taxable capital gain.

The rate of tax depends on at least four factors: the holding period, the tax basis of the property, recapture of depreciation and loss carryover.

- If you have owned the property one year or less the gain is considered a short term capital gain and taxed as if it was earned income.
- If you have owned the property more than one year the gain is considered a long term capital gain and taxed at 5% (if you are in the 10-15% tax brackets) or at 15% (if your tax bracket is above 15%).

There are special rules concerning the holding period for:

- Dealer property: the gain is taxed as ordinary income if the property is held for resale to others as part of the "dealer's" ordinary course of business.
- Inherited property: is automatically treated as "long term" regardless of how long it was held.
- Partnership property distributed to a partner: add the partnership's holding period to the partner's holding period.

And remember, there can be State and often local capital gains taxes.

Tax Basis

Calculate the capital gain by simply subtracting the property's tax basis from the net price (after expenses of the sale). For example if you receive \$100,000 for the sale of property with a basis of \$20,000, you experienced a capital gain of \$80,000. So how do you calculate your tax basis?

Let's say you had originally purchased that same property for only \$15,000, that you paid \$1,000 of allowed acquisition costs when you bought it, that later you spent \$6,000 for major improvements (you put a new roof on the building) and that, over the years, you took a total of \$2,000 in depreciation on your tax returns. Compute the basis as follows:

Calculation of Tax Basis:	From the example:
Initial Cost	\$15,000
plus Costs of Acquisition	\$1,000
plus Cost of Capital Improvements	\$6,000
minus Depreciation taken	(\$2,000)
Adjusted tax basis	\$20,000

The Initial Cost depends on whether the property was purchased directly, inherited or received as a gift.

- In a direct purchase the initial cost is the purchase price plus the acquisition costs (e.g., attorney's, inspection, processing and survey fees, title insurance, option cost, points, etc.)
- The tax basis of inherited property takes the property's fair market value as of the date of death of the decedent, regardless of the decedent's basis. That is the decedent's tax basis is stepped-up to the property's value at time of death. This could be a huge tax advantage and might be a reason not to donate certain property to your children because...
- If no gift taxes are paid, property that is gifted carries the original tax basis of the donor to the donee – i.e., no stepped-up valuation. If gift taxes are paid then the amount of tax paid is added to the original basis.

Minor improvements are usually expensed but the cost of major improvements (considered capital improvements) are added to the tax basis. If an insurance company reimburses any part of the cost of capital improvement then the reimbursement is subtracted from the basis (even if the reimbursement was more than the cost of the improvements).

So, for example, if property acquired for \$100,000 is damaged by a hurricane and then repaired for \$50,000 and the insurance proceeds are only \$40,000 the new basis is \$110,000 (i.e., \$100,000 + \$50,000 - \$40,000). But if the insurance settlement had been \$60,000, the new basis would be only \$90,000 (i.e., \$100,000 + \$50,000 - \$60,000).

Depreciation

Depreciation is a tax benefit – you can deduct (i.e., write off against your earned income) the value your investment property loses each year for ordinary wear and tear even though you had no out of pocket expense – deducted with no cash out.

Depreciation can be a most useful tool. And accelerated depreciation based on cost segregation analysis (i.e., depreciating the various building parts according to the life expectancy of each component) is allowable. Also special government programs are offered such as the Gulf Opportunity Zone (GO-Zone) allowing investors in the hurricane damaged areas an extra 50% bonus depreciation the first year investment buildings are placed in service.

Recapture of Depreciation

But if you sell the property (and cannot otherwise defer the tax), certain depreciation you claimed will be subject to a hefty tax – it is called recapture of depreciation and the tax rate is a flat 25%.

Loss Carryovers

High income earners would like to be able to deduct losses from their investment real estate activities against their income to lower their income taxes. Prior to 1986 that is what the IRS allowed – so a lot of doctors were buying apartment complexes as "tax shelters". But the tax reform act of 1986 severely limited this.

The limitation on passive losses (from participation in a trade or business other than your normal work, e.g., a rental property) depends on the taxpayer's income level.

- A small landlord is allowed to deduct no more than \$25,000 of such loss per year and must carry forward any excess to another tax year.

- High income earners are subject to an income phase out rule that reduces their deductible losses after their annual income exceeds \$100,000 and totally disallows the losses when their income reaches \$150,000.

If you have capital losses (from the sale of investment property) you can certainly offset them against your capital gains from other sales that same year but if your long term capital losses exceed such gains then only \$3,000 per year of your losses can be deducted against your current income. The balance of such losses must be carried forward to another tax year.

Disallowed capital losses

If you sell property to a relative the IRS may disallow the use of the loss as an offset to your capital gains. The IRS presumes that you intended to dispose of the property for an inadequate consideration even if that was not the case.

There are also some tax traps that phase out what you may deduct if you itemize deductions (on Schedule A) or claim childcare credits as your income reaches certain limits. And for purposes of these phase out rules recaptured depreciation and capital gains are considered as part of your "income".

Installment sales

In a seller financed transaction (where the seller gets a portion of the price at closing and the balance over time in installments) generally:

- All of the recaptured depreciation is immediately and fully taxable but
- The seller pays tax only on the percentage of the gain that was realized each year.

Seller sells for \$200,000 property with a basis of \$100,000 (as adjusted after \$20,000 of depreciation that had been taken) with Buyer paying \$90,000 cash at closing and giving Seller a promissory note to pay \$11,000 per year annually over ten years plus interest at the rate of 8% per annum.

Sale price	\$200,000
Minus adjusted basis (depreciation was taken out).....	(\$100,000)
Minus recaptured depreciation	(\$20,000)
Total gain	\$80,000
Gain as a ratio of the price (\$80,000/\$200,000).....	40%

Amount of price received first year	\$90,000
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Seller will pay taxes the first year on:

First year capital gain received (40% of \$90,000).....	\$36,000
Recaptured depreciation (100% of it).....	\$20,000
Interest income received that year (if any).....	Variable

Amount of price received each subsequent year \$11,000

Seller will pay taxes in subsequent years on:

Capital gain received that year (40% of \$11,000).....	\$4,400
Interest income received that year.....	Variable

But the seller may elect out of the installment sale and recognize the entire gain in the current year as if all of the money had been received.

Sale of primary residence

This is the best tax advantage given by the IRS – money free and clear of tax – up to \$250,000 on the sale of your personal residence is excluded from capital gains (the exclusion is up to \$500,000 for a married couple filing jointly). And you can exclude it even if you never buy another home. And you may take the exclusion again and again as long as the property that is sold will qualify as your personal residence.

- To qualify, you must have owned and lived there two of the last five years and must not have acquired the residence in a 1031 exchange within 5 years of the sale. But the 2-year occupancy rule may be relaxed in certain cases if, for instance, you are required to move as a requirement of your employment, your health or even for other unforeseen difficulties.

If any part of the home was used for home-business purposes, then the entire gain on the sale of the residence can be excluded up to the maximum allowable. That is, there is no percentage test. And any depreciation that had been claimed is subject to preferential treatment – it would be subject to tax as income to the taxpayer according to their tax bracket (i.e., it would not be subject to the higher 25% flat tax rate for "recaptured" depreciation).

The 1031 exchange

The mechanics of Internal Revenue Code Section 1031's like-kind exchange are set forth in the next chapter...

Chapter 3:

Introduction to 1031 exchanges

Complete and indefinite tax deferral...

An ambitious fellow by the name of Starker challenged the IRS back in 1921, using a procedure that he argued should allow the deferral of his taxes under the Law. He won the case and gave us what some of us even now call the "Starker Exchange" or the "1031 like-kind exchange". The rationale is that if you reinvest all of the proceeds from one investment into another without realizing any funds then you should not be penalized by paying a tax. In other words, it would be unfair to be penalized with taxes on a mere "paper" gain.

The beauty of the 1031 exchange in the world of real estate is that it not only completely and indefinitely defers both capital gains taxes and recapture of depreciation such that you are free to reinvest more, it also has a number of non-tax related benefits. It gives you opportunities, for example, to:

- Change the location of your real estate investments perhaps to:
 - Move them to a place nearer to your home, your work or your sphere of influence – even to a place where you might want to retire in the future
 - Have the property near where your children will be better able to tend to it for you
 - Invest in an area that is more inclined to appreciate in value
- Change the nature of those investments, for example, to:
 - Get properties with more (or less) cash flow

- Consolidate your holdings
- Scale down or break up your holdings perhaps to facilitate a community property settlement or a distribution to co-heirs
- Adjust your portfolio and the mix of properties, e.g., from unimproved land to income-producing residential, commercial, retail or other types of property and vice versa
- Accommodate management concerns such as exchanging properties requiring your personal management for institutionally managed real estate investments

...the possible combinations are endless.

Types of 1031 exchanges

Four distinct types of exchanges are allowed under the Internal Revenue Code.

- The simultaneous exchange requires the sale and purchase to take place on the same day – this was the most common type used before the 1984 tax reform act.
- An improvement and construction exchange is a complex and complicated (as well as expensive) procedure where you could acquire and construct the investment to become your "replacement" property when the improvements are complete but a third party qualified intermediary must take title and manage the property through the construction until the completed property is conveyed to you.
- A reverse exchange would enable you to acquire the new "replacement" property before the old "relinquished" property is sold. But "title" to the new property must be placed in "escrow" in the name of an "exchange accommodator titleholder" (an EAT) until you sell the old property which must be completed within only 180 days of the first acquisition.
- But the focus of this publication and most common type is the delayed exchange...

Delayed exchange

The delayed exchange is simple to perform – fill out the proper forms and follow strict IRS rules to handle the money, dispose of qualified property and replace it timely with other qualified property then file the proper tax return.

A misstep, however, can result in the disallowance of the tax benefits – the gains would become fully taxable and subject the parties to a costly unintended outcome.

What property "qualifies" under 1031?

A common misconception is that "like-kind" property as it relates to real estate means property in the commonly used sense of that term – that is not the case. You need not exchange office buildings for office buildings or unimproved land for other land or apartments for apartments. Section 1031 as it refers to real estate requires that "qualified" property be exchanged for other "qualified" property. So long as the properties are "qualified" and involve real estate the IRS considers them "like-kind" properties.

So if otherwise qualified, the following real estate exchanges, for example, would be permissible under 1031 – exchanges of:

Raw land	for	Improved property
Condominiums	for	Timber rights
Hotels	for	Drive-in movie parks
Oil and gas rights	for	Leasehold interests
Apartments	for	Easements or servitudes
Airports	for	Parking lots
Single family residences	for	Shopping centers
Hospitals	for	Chicken farms
Any of the above	for	Any other of the above...

...and probably a million more combinations...you get the picture.

Qualified property under 1031 includes real property (and other interests in real property) that is held for business or investment use.

Improved or unimproved property held for investment – for sale hopefully at a profit in the future – would qualify. The intent is the key. A condominium intended to be rented would qualify.

However, this would not include property "held for resale" or, put another way, purchased with the intention of immediate resale such as land to be subdivided. The "dealers" who buy and re-sell such properties do not really intend to "hold" the property for investment and would be required to pay ordinary income tax on their gains.

Real property used or intended to be used in trade or business, such as farm land used for growing crops, would also qualify.

But property "held for personal use" does not qualify. A property bought as a "vacation home" would fall into this category. So, too, your personal residence does not qualify for a 1031 exchange but, hello, you still get to exclude a huge capital gain when you sell it if it qualifies as your personal residence.

Please consider the following:

If you own the building in which you operate a video rental business, the building would qualify but the inventory (which is not real estate) would not.

Shares in a real estate investment trust (a REIT) are not considered real property (they are movable personal property) and would not qualify.

You could exchange your apartment building that you bought for a song years ago (qualified investment property) for an expensive condominium at the beach that you presently intend to rent out (another qualified investment property), get the advantage of 1031 indefinite tax deferral and then (after a reasonable period of time during which you reported your rental income on your tax returns) decide to change the use of the condo into your personal retirement home without any tax consequence then sell your primary residence (excluding up to \$250,000.00 of the gain, double that much if you are married filing jointly) and move to the beach. After you die, your heirs get the condo at the stepped-up tax basis equal to its value at the time of your death despite the fact that the condo tripled in value since you bought it and your tax basis was just a mere song the day before you died. And those "deferred" taxes simply go away. It's hard to believe but it is indeed legal.



Tax tip: How long must you "hold" the property before you can change the intended use of it from investment property into your personal residence? The IRS does not specify and I won't speculate. Some experts suggest that you should wait a "year and a half" or a "year and a day" so that the investment use of the property would be reflected on your tax return but we strongly suggest that you seek independent legal, accounting and tax advice.

Tax returns

One of the most common reasons a 1031 exchange will be "disallowed" by the IRS involves the filing of the proper tax return. IRS form 8824 must be filed with the taxpayer's return for the year of the initial 1031 transfer date. This company as your QI would, of course, give you a written summary to assist you and your tax preparer in filing your return and the IRS form 8824 may be secured from our website.

Your qualified intermediary

The "third party intermediary" that you are required to engage to manage and facilitate your exchange could be disqualified unless it follows the strict guidelines of the IRS. Those expressly disqualified from serving in such capacity would include your spouse, lineal descendant, employee, accountant, attorney, real estate agent or financial advisor. That is a reason why this company will not give you legal, accounting or tax advice.

If your QI violates any of the strict standards of the IRS, not only might that cause the IRS to disallow your own 1031 exchange but also it could put in jeopardy every 1031 exchange ever handled by that QI. So please do us both a favor, don't ask us to bend the rules – e.g., to back-date the "identification" of your replacement property or to prematurely refund your exchange funds from escrow. We know that want your qualified intermediary to strictly play by the book and we will always decline to commit tax fraud.

"Safe harbor" rule – waiting period

On the other hand, as long as your QI adheres to those strict standards, you can be sure that your exchange will be allowed. The important "safe harbor" rule prevents the exchanger from ever having actual or constructive receipt of the funds from the sale of the relinquished property. Such funds are held in escrow by the QI.



Escrow is not a big black bird: "Escrow" is the term to describe when money or property or documents are placed in the hands of a third party (often called a trustee, escrow agent or other fiduciary) to be held until the happening of some condition(s). In a 1031 context your QI will hold the proceeds of the sale of your relinquished property under the terms of a written exchange agreement to apply those funds to your acquisition of the replacement property. The agreement provides that any unused funds would be

returned to you and if the replacement property is not "identified" timely or its purchase is not completed timely (for any reason) then the funds must be returned to you.

But there is a minimum 45-day waiting period during which the QI is not permitted to release the funds. Funds in escrow can, however, be used for deposits on the replacement property and the exchangor may list the funds as an asset on loan applications. The QI, if requested by the exchangor, will routinely confirm to the exchangor's lender how much is being held in escrow.

The 45-day rule

The clock starts ticking after the first property is sold and the funds are escrowed then, with no exception, the exchangor must identify the replacement property within 45 days. The identification must be in writing and received by the QI within the time period. It must completely and unambiguously describe the property the exchangor intends to buy with the escrowed funds. Unless the written identification is received timely the QI must disburse the funds in escrow to the would-be exchangor and the opportunity for a 1031 exchange would be lost.

So as a potential exchangor you had better make sure that the deadline does not expire – that means you should certainly find the replacement property but you may want to wait until the last day to "identify" it because if you had already named another property and then changed your mind some most significant property identification consequences arise under either the "3-property identification rule" or the "200% of proceeds rule with the 95% exception"...

3-Property ID rule

As long as you officially "identify" not more than three properties it does not matter what the value of the properties may be. In such event you may buy any one, two or all three of the named properties.

But if for any reason you name more than three properties (this is dangerous) then you would be subject to the following...

200% rule and the 95% exception

If more than three properties are identified then the combined value of all identified properties may not exceed 200% of the net selling price of the relinquished property unless you purchase 95% of the values you identified – otherwise none of the properties will qualify for the 1031 exchange.

So, let's say you sell investment property at a net sales price of \$200,000.

If you identify one, two or three otherwise qualified properties with a combined value of \$1,000,000 (or any other value) that's okay – you can purchase any or all of them under the 1031 exchange arrangement even though the combined value in this example is 500% of the price of the relinquished property. Value does not matter if not more than three properties are identified.

But if you identified four or more replacement properties (that is, more than three) with a combined value of \$1,000,000, which is more than 200% of the price of the relinquished property (200% x \$200,000 is only \$400,000) then none of the identified property will qualify and you must forego the 1031 exchange unless you purchase as many of the identified properties as it may take to produce a combined value of \$950,000 (i.e., 95% of the total combined value of all identified property). In order to purchase them you might have to come up with a huge sum out of pocket because the funds in escrow with the QI would certainly be only \$200,000 or less.

But assuming you could indeed make the purchase then both the taxes on the gain and on any recaptured depreciation on the sale of the relinquished property would be deferred. Otherwise those taxes would be payable.

We would suggest that you stay away from ever naming more than three properties.

And assuming that you timely identify the properties you have another clock to beat...

The 180-day rule

As ever the clock starts ticking after the first property is sold and the funds are escrowed (and you have identified the replacement property within 45 days thereafter) and again with no exception, all of the property must be purchased within 180 days. The deadline is not 45 days plus 180 days – it is a total of only 180 calendar days from when the first property is sold.

Related party sales

You may buy property from related parties but if you sell relinquished property to related parties they must hold it two years or else your exchange may be disqualified.



Boot

We are not talking about football – boot is the colloquial term for taking cash out of an exchange. In a nutshell, the tax on the gain and recaptured depreciation are completely deferred in a qualified 1031 exchange if no "boot" is taken out. But if you want to take say \$10,000 from the sale and only escrow the balance with your QI to buy the replacement property then the \$10,000 cash boot will be subject to tax.

If, for instance, mortgaged property is exchanged for other mortgaged property of the same value but with a higher mortgage then taxable mortgage boot may result. Using some of the exchange funds to pay for non-allowable expenses can also cause boot.

To avoid boot, simply buy a property of equal or greater value than the net proceeds of your sale and spend all of the exchange funds.

For example, if you sell for \$200,000 and pay \$12,000 in allowable expenses (e.g., a 6% real estate commissions) and your mortgage balance was \$120,000, your net price is \$188,000 (\$200,000 - \$12,000) so after paying off the mortgage your exchange proceeds were \$68,000 (\$188,000 - \$120,000). To avoid boot:

1. You must buy replacement property for at least \$188,000.00 and
2. Spend all of the \$68,000 for the cost of the replacement property and allowable closing costs.

But say your replacement property costs only \$180,000 and you pay an additional \$3,000 in allowed acquisition costs. Forget for the moment about the mortgage on the new property (and put the concept of "equity" aside) – the cost of the replacement property was only \$183,000 and that is less than the net price you got for the relinquished property so you will have "boot" of \$5,000 (\$188,000 - \$183,000).

And this will be so even if the mortgage on the replacement property was only \$100,000 so all of the exchange funds (\$68,000) plus another \$15,000 had to come out of your pocket in order to pay for the property.

Sale price of replacement property.....	\$180,000
Plus allowed costs payable by buyer	\$3,000
<u>Minus mortgage loan balance.....</u>	<u>(\$100,000)</u>
Net funds due from buyer	\$83,000

<u>Less exchange funds from QI's account</u>	<u>(\$68,000)</u>
Net due from buyer's pocket.....	\$15,000

So you had to come out of pocket but still had to pay taxes on boot. With some tax planning you could have done a tax-free exchange with no cash out of pocket and later refinanced the replacement property to take out cash with no tax consequences but that is another story...

More tools for the investor

Let's now add a few more weapons to your arsenal...

Chapter 4:

Lesser known investment opportunities

Rethinking the real estate portfolio...

Since you have learned that with 1031 you can indefinitely defer taxes, you might want to rethink your real estate investment strategies – you might as well fully utilize your ability to take deductions for depreciation, for example, if you do not have to worry about ever paying tax on the recapture. But your new "dilemma" now becomes how to find suitable replacement properties.

This chapter focuses on a more aggressive depreciation technique and a couple of commercial real estate offering types that might greatly interest the real estate investor.

Cost Segregation Analysis

Ordinarily the tax law requires buildings to be depreciated over a period of time from 27.5 to 39 years – investors commonly use 30 year straight-line depreciation. But seldom does the wear and tear of a building in a year's time ever actually diminish its value by exactly one-thirtieth of its cost. The various components of structures wear out on different timetables.

Cost segregation analysis requires an engineer and an accountant to review construction costs of new buildings or improvements then to identify the different component parts and apply a "tax-life" to each component. The result will give a more accurate method of computing depreciation – reflecting, for example, that carpets wear out more quickly than do foundations. The depreciation schedule for the structure will be a number of schedules for its components – roof systems, walls, foundation, heating and air conditioning systems, etc.

The cost of the exercise of setting it up can be more than offset by major write-offs against the tax on rental income.

Remember, a reduced tax basis and depreciation recapture tax are no longer obstacles if, when the property is later "sold" it can be disposed of as part of a 1031 tax-free exchange.

Ways to make money in real estate...

A number of years ago a now deceased client of mine, who was a very colorful and wise 60+ year veteran commercial real estate developer and broker, explained what he characterized as the "two ways to make money in real estate" – he called them the theory of subdivision and the theory of syndication.

His theory of subdivision was simply to purchase property then sell off its smaller component parts – in other words, buy wholesale and sell retail. The theory is that the sum of the value of each of the parts ordinarily exceeds greatly the value of the whole, as a single unit. This theory covers, for example, the traditional subdivision of land into lots as well as the conversion of buildings into condominium units. Many believe that successful real estate developers are wealthy and can buy expensive land. My experience is that developers make their money when they buy – they follow this theory and they "buy right" on the speculation that they can sell the parts profitably.

He also said that he repeatedly observed from time to time in his career exceptional bargains in the real estate market that were great buys, value-wise, often because they were parcels or developments that were simply too big for ordinary investors. He was describing a real estate price niche that was too high for the individual investor yet too low for the institutional investor. Perhaps the bargain would simply be an undervalued property (perhaps a "distress sale") that could be sold in time at a higher price or maybe it would involve property that could be subdivided. His theory of syndication would cover such bargain opportunities – the theory was to "orchestrate" a group of investors with similar objectives to pool their resources and purchase the bargain properties jointly.

Now I intentionally chose the word, orchestrate, because in my experience even like-minded real estate investors with similar objectives tend to be highly opinionated, each with passionate ideas as to how particular projects should be handled – each would do it their own way. But they all generally want to make money with minimal risk and involvement. So to assemble the "group" it may be preferable to confidentially present such an investment opportunity to each potential investor as a complete "package" that they can analyze and either accept or reject.

Not surprisingly such "packages" for the real estate investor are already in the marketplace. Two not-so-commonly-known investment package types are what some would call tenant in common (TIC) investments and zero cash flow properties...

TIC – Tenant in Common

You may own real estate jointly with any number of other parties under an arrangement where your undivided interest in the property does not terminate upon your death but passes to your estate or heirs. At Common Law, this is called Tenancy in Common (TIC). Multiple investors often pool their funds to buy property under a TIC arrangement. The practice is a common way that shopping centers and large office and apartment buildings are acquired. As a TIC investor you not only own your undivided fractional interest in the property but you also share proportionately the net income and depreciation.

In 2002, IRS guidelines (Revenue Ruling 2002-22) specified that TIC's of up to 35 parties can qualify as like-kind replacement property. This presents a tremendous opportunity for investors because TIC's typically offer...

- Higher grade properties – the buying power of TIC's can acquire institutional quality properties that often attract more stable better-credit tenants.
- No management worries – professional property managers run the day-to-day operations.
- Higher returns on investments – TIC's are not risk-free but they can sometimes double or triple conventional investment property cash flow.
- Flexible pricing options – often the minimum TIC investment is \$200,000 but purchase requirements might be as low as \$50,000 and a "greater than minimum" investment may be made so as to exactly match, for example, the exchange funds dollars available (e.g., if after acquiring some 1031 replacement properties there are still \$234,567.89 available, it can all be invested into the TIC). And TIC's may be purchased with (recourse or non-recourse) mortgage debt so as to leverage the investment dollars.
- A TIC interest may be quickly acquired (to meet the 180-day rule) and thereafter is freely assignable – although there may be no established secondary market, you could sell it any time or leave it to your heirs.

Imagine the economic ramifications of combining both the theories of subdivision and syndication into a TIC project designed to take advantage of the GO-Zone tax benefits.

Zero Cash Flow properties

My brother said, "Yeah! I've had some zero cash flow properties...". We probably all can say that but I doubt that he was referring to the topic of this section...

By "Zero Cash Flow properties" we are certainly referring to investments in which the rental income collected is used up to service the rental expenses and mortgage payments. But here we are limiting the term to apply only to institutional quality properties with stable high-credit tenants – usually a single-tenant (such as Walgreens) in a triple-net leased property with 30-year lease terms and perhaps 25 year mortgage financing (often non-recourse *in rem* debt). Typically such properties can attract rental income that will cover expenses and 90% loan to value (LTV) mortgages – that means that a highly leveraged investment of only 10% of the price is all that is necessary to purchase such properties (as opposed to the 20% to 25% typically required for commercial properties).

The attractiveness of such investments as 1031 replacement properties allowing the exchangor to "cash out" is obvious since all "exchange funds" can be used to buy the properties and then they can be re-financed to take out up to 90% of the sale price in cash. Please notice the following scenarios as examples of what you could do.

Putting it all together

Just imagine combining these tax benefits – the preferential tax treatment of long term capital gains, the depreciation write-offs with no cash out-flow, the deferral of tax on installment sales, the stepped-up basis on inherited property and the exclusion of huge gains on the sale of your principal residence – with the advantage of Section 1031's complete and indefinite tax deferral. Many folks just cannot believe the things that can be done as explained in the next chapter.

So let's look at some things you could do...

Chapter 5:

Some solutions for investors

Taking what the IRS gives

Remember that there are benefits in the tax code – huge gains on each sale of your qualified personal residence avoids tax, you can write off depreciation even though you had no cash outlay, your long term capital gains are taxed at a reduced rate, you can defer taxes on installment sales, the tax basis on your inherited properties are stepped-up, and Section 1031 can let you defer tax indefinitely. So what practical examples can we suggest to you?

What follows are adaptations of real-world examples illustrating ways you can put these principals to work for you.

The IRS wake-up call

How can I sell my property, keep some cash and get a retirement home?

Let's say you have a potential buyer willing to pay \$431,200 for your four-plex apartment building that is free and clear of any mortgage. Your CPA says if you sell it the tax bill would be \$100,000. This is how most folks first learn about 1031. You want to buy a beach house on the Florida gulf coast for about \$200,000, lease it out a few years then sell your residence and retire in the beach house. And you would like \$80,000 in cash to pay some bills. What could you do?

Get with your IRS Qualified Intermediary...

Refinance the four-plex for \$80,000 and use the loan proceeds to pay off the mortgage on your personal residence (which reduces your monthly expenses).

Nine months later "sell" the four-plex for \$431,200 under 1031 and deposit the \$312,000 proceeds (after expenses and pay-off of the mortgage) with your QI then spend \$193,600 for a beach house in Panama City and spend the remaining \$118,400 to buy a tenant in common (TIC) interest* that comes with a \$82,278 non-recourse mortgage debt (your share) and a AAA-rated triple-net lease with net cash-flow after debt service of about \$720.00 per month (about 7.125% net earnings on your investment) with no management headaches.

*You actually purchase an undivided interest in a \$2,000,000 property with an *in rem* mortgage of \$820,000 (about 41% loan to value) – you put up 10.0339% of the \$1,180,000 equity, namely you invest \$118,400.

Rent out the beach house until you are ready to retire in three years (you cannot use it personally more than 2 weeks each year). Then sell your residence with \$250,000 of the gain tax free (\$500,000 if married filing jointly) and move to Florida.

Remember had you originally sold the four-plex, paid the tax and taken out the \$80,000 in cash you would have had only \$251,200 left to invest – at 5% annual return you could have "grown" it to about \$291,000 when you retire. Compare what you accomplished with the 1031 exchange.

Instead you still got the \$80,000. You got the \$700/mo. cash-flow on the TIC (over \$25,000). You spent a couple of weeks at the beach each year and got substantial net beach house rental income. You will retire with at least 100% of the proceeds of the sale of your residence and, assuming the same 5% inflation per year, you will then also have:

Beach house worth at least	\$224,000
TIC interest worth at least	\$150,000
Total value of real property.....	\$347,000

...and you did not have to invest a penny of your other funds plus you did not owe one cent of taxes.

Now let's swing for the fences



How can I sell my property and keep most of the cash but pay no taxes?

You obviously aren't the first one to think of that question. The amazing thing is that we can indeed, using a 1031 exchange, give you the answer you probably want to hear. If you have investment property with a large value and a lot of equity you could do it. Let's say your low tax basis property is worth \$3,000,000.00 with mortgage debt of only \$1,000,000.00. Perhaps you have even taken a great amount of depreciation over the years. You cannot afford to sell it outright because the local, state and federal tax consequences of the depreciation recapture and capital gain would be immense.

But you could probably find what we call a "zero cash flow" property starting for about \$2,000,000.00 – a property with a single AAA-rated tenant with a 30 year "triple-net" lease with built-in rental increases, perhaps a national pharmacy chain store.

If you net about \$2,000,000.00 on the sale of your "relinquished" property which would go into your QI's exchange account then use those funds to purchase the drug store property with complete tax deferral and thereafter (here's the key) place a mortgage on that "replacement" property for \$1,600,000.00 (which is only about an 80% LTV) the net income would likely cover a 25-year loan and you would have received the lion's share of your cash with no tax.

Of course your tenant's rentals would continue and escalate for 25 years until the mortgage is satisfied and thereafter you would start netting about \$12,000.00 to \$15,000.00 a month until you decide to "sell off" – well, you will probably then do another 1031 exchange.

And if you should die, your children will inherit the property at its stepped-up (to its value at the time of your death) tax basis and they could then either enjoy the cash flow or sell it with little capital gain.

But, shhhh, let's keep 1031 a secret...

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Bob Calongne has been engaged in the full time practice of law since 1974 and has been admitted to practice in both Louisiana and Florida. Having graduated from St. Thomas High School in Houston, he earned the Juris Doctorate degree from the L.S.U. Law Center and has a Bachelor of Arts degree in Economics from L.S.U. in Baton Rouge.

His legal practice has principally centered about finance - dealing with real estate finance, trusts, estate planning, lender liability, bankruptcy and commercial matters. He started in private practice in Baton Rouge from 1974 until taking the position as Vice President, Southern Regional Manager and Underwriting Counsel of United General Title Insurance Company in 1997, heading the Baton Rouge office until being promoted to the Company's executive offices in Denver in 2001.

His title industry "savvy" is exceptional - not only is he experienced as a long-time title policy issuing agent and practicing commercial real estate attorney, he has also served in the national title underwriter business as manager of multi-state marketing, as regional and national underwriting counsel, as claims counsel and as the coordinator of special projects such as spearheading company licensing in new states and developing cutting-edge technological techniques and procedures. He developed software that calculates title insurance premiums and software for lenders to calculate premiums and filing fees for their "good faith estimates".

He organized and manages 1031 Exchange Counsel, LLC, an IRS 1031 Qualified Intermediary. He closes real estate transactions for various title companies. He does title underwriting on a regular basis (i.e., advises title insurance agents) in several states for United General Title, a division of First American Title Insurance Company.

He has written articles on real estate title subjects and has regularly conducted seminars on real estate, estate planning and trusts not only for the public but also for real estate agents and attorneys to meet their legal educational requirements.

Mr. Calongne was a commissioned officer in the United States Navy and served aboard the *USS SARATOGA* during the Vietnam years and had previously worked for the Boeing Company at the Florida Kennedy Space Center in connection with the Saturn V project. He has been a director and officer of the public corporation, Gulf Union Industries, and its subsidiaries. He has served in executive leadership positions with numerous organizations including the Capital City Kiwanis Club, the Inter-Civic Council, the River City Festivals Association, First Presbyterian Church and the Baton Rouge Christian Counseling Center. He and his wife, Mary Garner DeVoe, live in Baton Rouge.

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Index

0-9

1031, IRC Section, 0, i, 1, 2, 3, 4, 7, 11, 12,
13, 14, 15, 16, 17, 18, 21, 22, 23,
24, 25, 26, 27
1099-S, IRS Form, 4
180-day rule, i, 18, 23
200% rule, i, 17
3-Property ID rule, i, 17
45-day rule, i, 17
8824, IRS form, 16
95% exception, i, 17

A

AAA-rated, 26, 27
After-tax dollars, 1
Albert Einstein, 2
Allowable expenses, 19

B

Boot, i, 19

C

Capital gains, 3, 4, 7, 8, 10, 11, 12, 24, 25
Capital Improvements, 8
Cash boot, 19
Compound interest, 2
Construction exchange, 13
Cost segregation analysis, 5, 9

D

Dealer, 7
Delayed exchange, 13
Depreciation, 4, 7, 8, 9, 10, 11, 12, 18, 21,
22, 23, 24, 25, 27

E

Elect out, 11
Escrow, 16
Exchange accommodator titleholder (EAT),
13

Exchange account, 4, 27
Exchange agreement, 16

F-G

Gifted property, 8
GO-Zone, 9, 23
Gulf Opportunity Zone, 9

H

Home-business, 11

I

Income bracket, 6
Initial Cost, 8
Installment sale, 11
Institutional quality properties, 23, 24

J-L

Like-kind, 1, 4, 7, 11, 12, 14, 23
Loan to value (LTV), 24, 26, 27
Long-term capital gain, 2
Loss carryover, 7

M

Mortgage boot, 19

N

Non-tax related benefits, 4, 12

O-P

Partnership, 7
Passive income, 4
Personal use property, 15
Price niche, 22
Primary residence, i, 11, 15

Q

Qualified, i, 4, 7, 13, 14, 15, 16, 18, 25

Qualified Intermediary (QI), 0, 4, 6, 16, 17,
18, 19, 25, 26, 27

Qualified primary residence, 4

R

Recapture (of depreciation), 4, 7, 9, 12, 21,
22, 27

Related parties, 18

Relinquished property, 16, 17, 18, 19

Replacement property, 4, 16, 17, 18, 19, 20,
23

Retirement home, 4, 15, 25

Reverse exchange, 13

S

Safe harbor, i, 16

Short-term capital gain, 7

Simultaneous exchange, 13

Single-tenant, 24

Starker, 12

Stepped-up tax basis, 4, 7, 8, 15, 24, 25, 27

T

Tax basis, 4, 7, 8, 9, 15, 22, 25, 27

Tax benefits, 7, 14, 23, 24

Tax fraud, 16

Tax rate, 3, 6, 7, 9, 11

Tax-deferred, i, 2, 4

Tax-life, 21

Tenant in common property (TIC), i, 5, 22,
23, 26

Theory of subdivision, 22

Theory of syndication, 22

Triple-net lease, 24, 26

U-Z

Zero cash flow property, 5, 22, 23, 27

NOTES