THE POWER OF STRATEGY

Mastering Advanced 1031 Exchange Issues

Presented by:

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Instructor: Pamela A. Michaels

- Vice President of Asset Preservation, Inc. (API)
- API has facilitated over 150,000 exchanges
- 25 + years combined 1031 exchange/legal experience
- Over 500 CLE/CE/CPE presentations on 1031 exchanges
- Instructor for many trade organizations

Capital Gain Taxation

- 20% capital gain tax rate for high earners
- New "net investment income" 3.8% Medicare surtax pursuant to IRC Section 1411
- Capital gain taxation now includes 4 components:
  1) Taxation on depreciation recapture at 25% - *plus*
  2) Federal capital gain taxes at 20% (or 15%) - *plus*
  3) 3.8% Medicare surtax on net investment income - *plus*
  4) The applicable state tax rate (0% - 13.3%)

Capital Gain Taxes

- Investors owe Federal capital gain taxes on their economic gain depending upon their taxable income.
- A rate of 20% has been added to the tax code for investors exceeding the $400,000 taxable income threshold for single filers and married couples filing jointly with over $450,000.
- The capital gain tax rate of 15% remains for investors below these threshold income amounts.

This valuable information provided by Pamela Michaels, Esq., Vice President of Asset Preservation, Inc.

3.8% NIIT Tax (IRC §1411)

- The Health Care and Education Reconciliation Act of 2010 added a new 3.8% Medicare Surtax on "net investment income."
- This 3.8% Medicare surtax applies to taxpayers with "net investment income" who exceed threshold income amounts of $200,000 for single filers and $250,000 for married couples filing jointly.
- Pursuant to IRC Section 1411, "net investment income" includes interest, dividends, capital gains, retirement income and income from partnerships (as well as other forms of "unearned income").

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The Code

"*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 or for investment.*"

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Exceptions

- Stock in trade or other property held primarily for sale
- Stocks, bonds, or notes
- Other securities or evidences of indebtedness or interest
- Interests in a partnership
- Certificates of trust or beneficial interest
- Choses in action

Property Held for Sale

- The purpose for which the property was initially acquired
- The purpose for which the property was subsequently held
- The purpose for which the property was being held at the time of sale
- The extent to which improvements, if any, were made to the property
- The frequency, number and continuity of sales
- The extent and nature of the transaction involved
- The ordinary course of business of the taxpayer
- The extent of advertising, promotion of the other active efforts used in soliciting buyers for the sale of the property
- The listing of property with brokers

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Like-Kind Property Issues

- **What Property is Excluded?**
  - Principal Residence
  - Property Held for Sale / Dealer Property
- **Qualifying Real Property**
  - Any real property held for productive use in a trade or business or investment = real property held for productive use in a trade or business or investment
- **Qualifying Personal Property**

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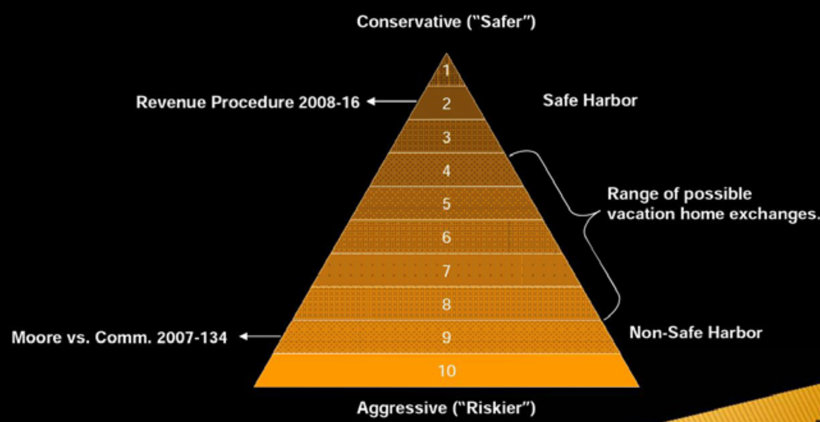
Vacation Homes

Exchanges of vacation homes held for investment are possible, provided the primary reason is holding for investment and not for personal use.



Vacation Homes

Revenue Procedure 2008-16

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

Requirements:

- The relinquished and replacement properties are owned by the taxpayer for at least 24 months (the qualifying use period);
- Within each of these two 12 month periods constituting the qualifying use period the taxpayer must.
- Rent the property to another person or persons at fair market rent for 14 or more days (family members qualify if they rent at fair market value); and
- The taxpayer's personal use of the dwelling unit cannot exceed the greater of 14 days – or – 10 percent of the time it is rented.

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Intent to Hold for Investment

- "Intent" is the taxpayer's subjective intent
- The IRS will look at objective factors that either support or negate the taxpayer's intent to hold for investment
- All facts and circumstances taken into account
- The holding period is just one (of many) factors
- Ideally the taxpayer has multiple factors to establish the intent to hold for investment
- Contrary facts may lead the IRS to conclude the property was not held for investment purposes
- Goolsby v. Commissioner (2010)
- Reesink v. Commissioner (2012)
- Allen v. United States (2014)

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Goolsby v. Commissioner

- Case where facts <u>did not support investment intent</u>
- Taxpayer moved into the property after only 2 months
- Sold principal residence around the same time
- Replacement property could not be rented per HoA
- No attempts to rent the replacement property
- Finished basement shortly after acquiring
- Non-privileged conversations with Qualified Intermediary taken into account

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Reesink v. Commissioner

- Recent case where facts did support investment intent
- Taxpayer placed many rental flyers throughout town advertising their house as available for rent
- Taxpayer showed house to two potential renters
- Taxpayer refrained from using the property for recreational use prior to moving into property
- Taxpayer sold their residence 6 months after purchasing replacement property in an exchange
- Taxpayer moved into property 8 months after acquiring
- Other supporting facts

Allen v. United States

- Taxpayer was not able to prove their intent changed from holding for development to holding for investment.
- Allen purchased property in 1987, and from 1987 to 1995 Allen attempted to develop the property on his own.
- From 1995 to 1999, Allen brought in partners who contributed capital for development.
- In 1999, Allen sold the property to a developer.
- Allen made significant and extensive efforts to develop the property over many years, and failed to substantiate when his actions changed with regard to the property.
- Ultimately, Allen failed to provide any evidence to prove that his intent changed during the time of ownership of the property.

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The Exchange Equation

For full tax deferral, a Taxpayer must meet two requirements:

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

	Relinquished
Value	$900,000
- Debt	$300,000
- Cost of Sale	$60,000
Net Equity	$540,000

The Exchange Equation

For full tax deferral, a Taxpayer must meet two requirements:

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

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

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The Exchange Equation

For full tax deferral, a Taxpayer must meet two requirements:

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

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

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

Analysis: There is no boot.

The Exchange Equation

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

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

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

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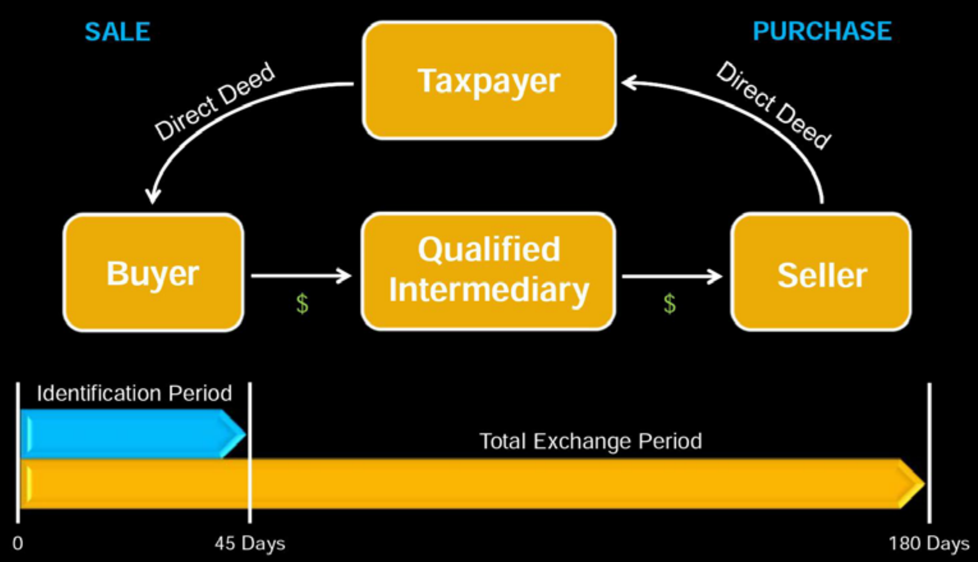
The Exchange Equation

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

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

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

The Delayed Exchange



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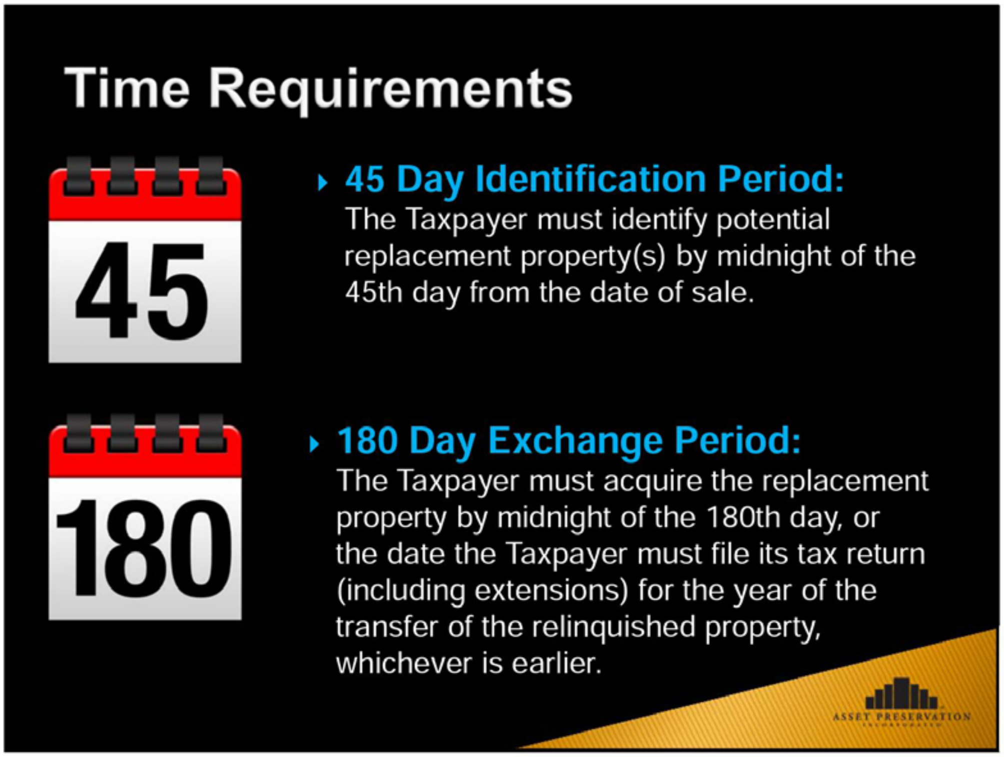

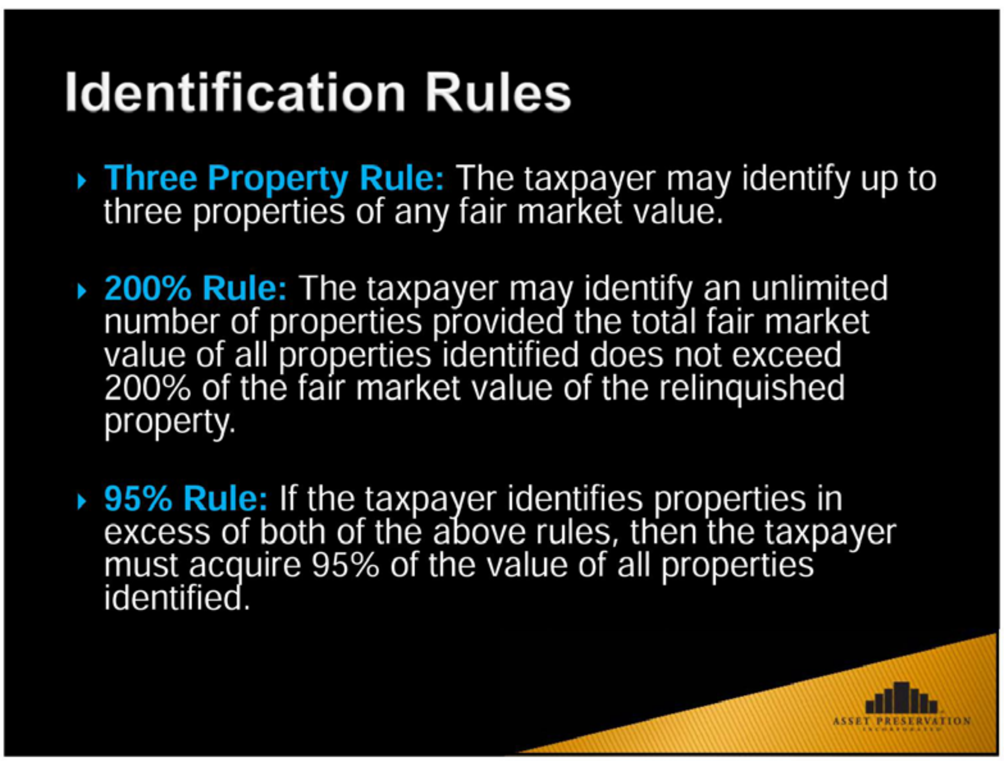

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Identification Rules

Identification must be:

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

Parking Arrangements

What is a Reverse Exchange?

- Purchasing the replacement property before the sale of the relinquished property.

What is an Improvement Exchange?

- Building a new replacement property from the ground-up or making improvements to an existing replacement property.

What is a Reverse/Improvement Exchange?

- Purchase the replacement first and begin construction before closing on the sale of the relinquished property.

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Rev. Proc. 2000-37

Effective September 15, 2000

- Provides a "safe harbor" for reverse exchange transactions that stay within the parameters of the Revenue Procedure.
- Reverse exchanges may be structured outside the safe harbor.

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Reverse Format

Replacement Property Parked

- **Positives**
  - Exchange equity need not be present
  - Allows for multiple relinquished properties
- **Negatives**
  - Lender may have issues lending to EAT

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Reverse Format

Relinquished Property Parked

- **Positives**
  - Loan and purchase easier (direct loan to Taxpayer)
- **Negatives**
  - Equity and debt should match to avoid boot
  - Lender issues (due on sale & prepayment penalties)

Improvement Exchange

Why Perform an Improvement Exchange?

- The replacement property to be acquired in the exchange is not of equal or greater value to the relinquished property.
- Build a new replacement property from ground-up.
- The replacement property is of equal or greater value, but it needs refurbishments.

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Improvement Exchange

> *"…if not within the provisions of Section 1031(a) if the relinquished property is transferred in exchange for services (including production services). Thus, any additional production occurring with respect to the replacement property after the property is received by the taxpayer will not be treated as the receipt of property of like-kind."*

Improvement Exchange

How do the numbers work out?

Relinquished Property	
Sales Price	$1,000,000
Debt	$0
Cost of Sale	$70,000
Net Equity to QI	$930,000

Replacement Property	
Lot Purchase (cash)	$600,000
Draw 1 - Site Work	$100,000
Draw 2 - Foundation	$230,000
Exchange Value	**$930,000**

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QI Due Diligence

- This is the most important choice a taxpayer will make in a Section 1031 exchange.
- Paramount to every 1031 exchange is the safety of funds held by the Qualified Intermediary (QI).

QI Due Diligence

- Does the QI offer customers the written backing of a large creditworthy entity?
- What is the financial rating and balance sheet of this entity?
- Does the QI conduct due diligence on the depositories holding the funds and monitor them?

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QI Due Diligence

- Does the QI offer segregated accounts?
- Does the QI offer a qualified escrow account?
- Does the QI offer a qualified trust account?
- Does the QI have sufficient fidelity bond coverage?

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Question and Answers

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