Sell An Investment Property For A Profit...Only To Be Drained by Taxes? NO More!...ZERO OUT Taxes With...

THE 1031

MONEY MACHINE

Rollover Your Investment Properties *Tax-Free* With The "1031 Tax-Free Exchange"

ALBERT AIELLO
William Noll, Esq, Cpa

New Fourth Edition, Updated for Latest Changes

Written in Easy-To-Understand Language

ISU\Information Services Unlimited

The 1031 Money Machine

Table of Contents

See attached for about Al Aiello and other info.

ALBERT AIELLO, BACKGROUND IN 1031 EXCHANGES

* Since 1979 has been involved in *thousands* of exchanges
* Sets up operating systems for 1031 exchange intermediary companies for others
* Consultant to other 1031 exchange intermediaries
* Author of many publications on 1031 exchanges
* Author of hundreds of articles on 1031 exchanges
* Author of award winning cover article for a national magazine
* Designer of Exchange materials used in courses & seminars nationwide
* National lecturer on 1031 exchanges
* GRI instructor on 1031 exchanges
* Professor of Real Estate & Exchange taxation for several institutions
* Certified Public Accountant (passed CPA exam in *one* sitting - 1978)
* Licensed Real Estate Broker
* Masters In Taxation (perfect 4.0 GPA)
* Active Real Estate Investor

***"Albert Aiello is one of the most trusted scholars in real estate and 1031 exchanges in the country"*...Al Brindisi, CPA, Former IRS trainer.**

1031 PUBLICATIONS WRITTEN BY ALBERT AIELLO

- *The Tax-Free Sales of Investment Properties Through 1031 Exchanges*
- *The Realtor Marketing Guide To The Tax-Free Sales of Investment Properties*
- *Tax-Free Exchanges and Vacation homes*
- *Tax-Free Exchanges In A Nutshell*
- *Exchanges and B & B's*
- *Exchanges - 18 Frequent Misconceptions That Can Cost You Money !*
- *The 1031 Money Machine*
- *1031 Tax-Free Exchanges: Financial Analysis & Strategies*
- *Turbo-Exchange* (forms & software package for 1031 exchanges).

For more about Al Aiello publications visit www.REINFO.com.

What Does CESI Do For You That Separates It From The Rest?

According to IRS regulations, ALL exchanges (delayed and simultaneous) must use an independent "Qualified Intermediary" (or "QI"), who will enable your exchange to qualify as a tax-deferred exchange under Section 1031{IRS Regulations 1031(k)-1(g)(4); 1031(b)-(2)}.

As a full service "QI" CESI will do the following:

- ✓ Provide you with highly competent 1031 tax advice that most "Qualified Intermediaries" are not trained or experienced to deliver. This alone will save you substantial amounts in Taxes.
- ✓ Prepare all of the required exchange documentation that is in strict accordance with current IRS regulations. This creates an audit-proofing wall against the IRS.
- ✓ Give the title or closing company special instructions so that they can properly prepare your "1031 settlement sheet" and the correct 1099 for your exchange. This creates the necessary IRS audit trail of safety.
- ✓ Give you Security for Your Escrowed Funds. We use bonded and insured reputable institutions to safely escrow your funds. You will be worry-free about the handling of your funds.
- ✓ Send you 1031 advisory instructions informing you of the essential exchange time deadlines and other important matters concerning your 1031 rollover. This will prevent you from making costly mistakes.
- ✓ Give you a written Guarantee of your Exchange qualifying within IRS regulations.
- ✓ Free expert back-up Audit Representation, in the event of an IRS Audit of your Exchange.
- ✓ You will legally save taxes and not have to lose sleep, worrying about the IRS because of these Expert Specialized Services.

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I . WELCOME TO
THE 1031 MONEY MACHINE

As we will learn in the next section, under Internal Revenue Code Section a 1031, an exchange (or rollover) is a technique that allows you to defer taxes on the sale of your investment property by acquiring another investment property within certain IRS requirements. Under Section 1031, owners of investment real estate do not have to pay taxes when they dispose of their property - not even if it has doubled or tripled in value -- so long as they rollover their property into other investment real estate. In fact, the exchange is usually not a direct swap, and in most cases will appear quite similar to a traditional sale and purchase. The main difference is that you pay NO taxes on the profit.

Exchanges are one of the most extraordinary of all tax reduction techniques for conserving real estate wealth. In fact they are powerful vehicles of wealth accumulation. Why is this so? Because, along with the power of leverage, you can pyramid the tax savings into a substantial amount of real estate ownership, that you would otherwise not have without the 1031. For instance, let's say you can save $15,000 in capital gain's taxes by doing a 1031 exchange. **As a 10% down payment, the tax savings of $15,000 enables you to acquire an <u>additional $150,000 worth of real estate</u>**! Keep in mind that's *additional*!!

Unfortunately, exchanges are still little known and used because of so many costly misconceptions. These misconceptions, along with more of the wealth accumulation power of 1031's, will be discussed in the next section.

The *1031 Money Machine* unlocks the mystery of 1031's by describing the entire 1031 process in detail, using a vast array of real-life scenarios. It shows more ways how to use the powerful 1031 than any other book ever written! It will show you the following:

* **Convert non-income property into spendable positive cash income** (Section VIII-2)
* **Takeout out tax-free cash** (Section VI)
* **Increase cash flow 5-fold or better** (Section VIII-4)
* **Double & triple your equity** (Section VIII-4)
* **Free yourself of tenant management** (Sections VIII-9 & 10)
* **Acquire a property that does not exist** (Sections VIII-11 and 12)
* **Expand your business** (Section VIII-8)
* **Move closer to retirement, conserve your estate, reap *permanent* tax savings** (VIII-24)
* **How to use 1031 for your *dream home* in *paradise!*** (Section IX)
* **Combine 1031 magic** with ***leverage*** (VIII-1), ***options*** (VIII-16), ***leases*** (VIII-14), ***easements*** (VIII-17), ***single family homes*** (VIII-7), ***ground leases*** (VIII-15), ***estate planning*** (VIII-24), ***asset protection*** (VIII-23), ***the tax-free sale of your home*** (VIII-20), ***private annuity trusts*** (VIII-25), ***family limited partnerships*** (VIII-24) **and more**!

The 1031 Money Machine will discuss creative and complex exchanges, such as

- **CONSTRUCTION (OR "BUILD-TO-SUIT") EXCHANGES:** Where the investment owner wants to build or improve the replacement property that will be purchased from an outside seller. (Section VIII-11)

- **CONSTRUCTION EXCHANGES ON PROPERTY ALREADY OWNED BY THE INVESTOR:** Where the investment property owner wants to build or improve on replacement property that they already own. Here, certain steps must be taken to accomplish a qualifying 1031. (Section VIII-12)

- **REVERSE "STARKER" EXCHANGES**: Where the investment owner must acquire the replacement property *before* they close on their relinquished property. (Section VIII-13)

- **REVERSE/CONSTRUCTION EXCHANGES:** Where the investment property owner needs to accomplish *both* a reverse and construction exchange into one exchange transaction. (Section VIII-13A)

- **PARTNERSHIP SPLIT-UPS:** Many times with a disposition of partnership property, the partners want to go their separate ways. Because an individual "partnership interest" does not qualify in a 1031 exchange, certain steps must be taken to accomplish a qualifying 1031 exchange. (Section IV, under the like-kind requirement)

- **SELLER-FINANCING:** If the exchangor takes back any seller-financing on the sale of the relinquished property, the takeback portion of the selling price does not qualify for 1031 non-recognition treatment However, the cash portion does. There are certain strategies that can make the entire transaction (including the seller-financing portion) qualify as a 1031 exchange. (Section VIII-19)

- **PROPERTIES QUICKLY SOLD:** These types of exchanges could violate the exchange "holding requirement". However, in certain situations and with advanced planning, these still may qualify. (Section IV, last part of this section)

- **OTHER COMPLEX EXCHANGES:** Large commercial transactions (Sections VIII-10,25), development-type property (Section IV), mixed-use property (Section VIII-20), personal property (Section IV), vacation homes (Section IX), foreclosures (Section VIII-18).

The 1031 Money Machine is the ultimate guide to 1031 exchanges.

As they say in the Opera *I Pagliacci* - "On With The Show!"...to the next section.

II. WHAT ARE EXCHANGES?

WHY CAN THEY ACCUMULATE WEALTH?

WHEN *NOT* TO EXCHANGE

<u>NEVER AGAIN</u> DO YOU HAVE TO PAY *ANY* TAXES ON THE SALE OF YOUR INVESTMENT PROPERTIES *(REGARDLESS OF WHAT TAX RATES ARE!).*

YOU CAN HAVE *<u>FULL USE</u>* OF YOUR EQUITY SO YOU COULD ROLLOVER INTO SUPERIOR INVESTMENT PROPERTIES WHICH IN TURN WILL FURTHER COMPOUND YOUR WEALTH

WHAT IS A 1031 EXCHANGE ?

Briefly stated, a 1031 exchange is a legal IRS provision that allows a property owner to avoid taxes on the sale of their investment/business real estate by acquiring another like-kind* investment/business property within certain IRS requirements & time limits (covered in Section IV). {***“Like-kind”*** is a broad category of reinvestment options covered in Section IV}

A VEHICLE OF WEALTH ACCUMULATION & A MARKETING TOOL

One of the most overlooked *vehicles of wealth accumulation* for real estate investors (small and large) is the “1031 Exchange”. It is also a cutting edge *marketing tool* for *both* residential and commercial RE sales professionals. Approximately 60% of exchanges are residential rental properties of 1 to 4 units and the other 40% are commercial. The 1031 exchange is an *integrated* topic (residential & commercial).

EXCHANGES ARE GENERALLY NOT "EXCHANGES" OR 2-WAY BARTER!

One of the biggest misconceptions about exchanges is that they are "pure" exchanges or 2-way barter. This is generally not so. Here is what typically happens:

⇒ At the first settlement you sell ("exchange") your relinquished property to "Joe Buyer"

⇒ At the second settlement you will acquire the replacement property from another person, let's say, "Mary Seller"

⇒ Joe Buyer and Mary Seller will have nothing to do with the exchange

⇒ The above settlements must be performed within 180 days of each other

⇒ Under specified IRS regulations (see Section IV)

⇒ Including using a *Qualified Intermediary* (see Section IV).

When you hear the word "EXCHANGE", think of *at least* *2 Closings* (and 2 Commissions, if you are a Realtor)

NOTE: 2-Party direct exchanges happen occasionally. They generally occur amongst a closed circle - relatives, friends or acquaintances.

RECOMMENDATION: Outside of the above closed circle, you should generally try to avoid a 2-party exchange, because such a "marriage" is difficult to structure. The proven result has usually been wasted time, effort and expense. Again, typically you will need to find "Joe Buyer" for your relinquished property and find a replacement property from "Mary Seller". (Joe Buyer & Mary Seller have nothing to do with the exchange.)

TAX TIP: If you do a 2-party exchange, you should still follow the IRS safe harbors including using a *Qualified Intermediary* (discussed in Section IV)

BASIC CONCEPTS OF WEALTH ACCUMULATION

Before further discussing 1031 exchanges, you will have a better understanding of their importance if you first review these basic concepts of wealth accumulation:

LEGAL AVOIDANCE OF THE "TAX DRAIN" and "TAX-FREE ROLLOVERS

In our lifetime unless we employ strategies such as 1031, one-third of our hard earned resources will be depleted by taxes. Take $1.00 and double it Tax-Free for 20 years and it will be worth over a MILLION dollars. Take that same $1.00, taxed every year at 35%, it will be worth only about $22,000 - A LOSS of a MILLION DOLLARS! Wealth is accumulated by preventing the "tax drain". The taxes saved can be reinvested to accumulate wealth faster. The tax law gives you a multitude of ways to legally avoid taxes. One way to avoid taxes (and accumulate wealth) is the employment of "Tax-Free Rollovers".

A *Tax-Free Rollover* is a legal strategy to avoid taxes on the sale, transfer or disposition of assets by reinvesting in other qualifying assets within certain time periods and under specified IRS rules. Rollovers allow earnings & profits to compound Tax-Free. The purpose of rollovers is to improve the equity position of an investment portfolio and thus enhance the wealth of the individual.

"LEVERAGE" - Using other people's financial resources (such as a mortgage) to control more value and derive more profit. Leverage increases buying power which in turn increases wealth. Real estate is the undisputed SUPERSTAR of leverage.

"COMPOUNDING" - Earnings accumulate not only on the principal amount of money but ALSO accumulate on the earnings as well. ("*Earnings on Earnings*"). Thus compounding *combines* earning power on principal <u>and</u> earning power on interest. As a result of this phenomena, money over the path of *time* grows much more rapidly. Asset appreciation is generated by compounding. Real estate is a natural with compounding, especially when *combined* with *leverage*. The best definition of compounding that I ever saw is:

> "Compounding is a silent powerful wealth building force that without notice can make you wealthier & wealthier. It is a *money-growing-cycle* that begins when each one of your investment dollars starts earning more dollars. Those earnings in turn join forces with invested dollars to keep repeating the money-making process. Compounding money at high rates of return is a definite advantage of real estate."

(Source - From an article by Jay DeCima in *Financial Freedom Report Quarterly* (Summer 1995. This publication is now out of print)

THINK OF A TAX-FREE 1031 EXCHANGE SIMILAR TO AN IRA ROLLOVER

EXAMPLE - IRA - COMBINING TAX-FREE ROLLOVERS & COMPOUNDING

You have IRA 1 - $50,000
only earning 4% interest

You want to roll over IRA 1 into
IRA 2 - earning 7% INTEREST

1. In 15 years the $50,000 4% IRA would grow to $90,000. However in the same 15 years, the superior 7% IRA would grow to **$138,000.**

2. A SIGNIFICANT DIFFERENCE OF $48,000 and it all can be TAX-FREE because under certain IRS guidelines you can rollover the entire $50,000 from IRA-1 > Into > IRA-2, Tax-FREE.

3. If you rollover $40,000 (instead of $50,000), you will avoid tax on the $40,000 and the other $10,000 will be taxed. You can have a part *tax-free* rollover and a part *taxable* transaction.

HOMEOWNERS HAVE BEEN USING THE POWER OF TAX-FREE ROLLOVERS FOR YEARS -- Under prior law, homeowners had two excellent provisions to shelter taxes on the sales of their principal residences:

1. IRS SECTION 1034: (Also called, "The Section 1034 Rollover" or "the Two-year Rollover"). Under Section 1034, homeowners could defer the capital gain tax on the sale of their home by reinvesting ("rolling over") into another home of equal or greater value within two years.

NEW '97 LAW: Effective May 7, 1997, the above provisions are replaced with **exclusions of $250,000/$500,000 of gain.** Homeowners can now avoid tax on gain of up to $250,000 of capital gains if single (or *individually* to each married spouse). The exclusion increases to $500,000 of gain if married and filing jointly. To be eligible for the exclusions the homeowner does not have to buy a replacement home. This gives many homeowners the option of moving down to a lesser expensive home without being taxed.

OLD OR NEW LAW -- THE HOMEOWNER CAN USE THE TAX-FREE PROFITS FOR A SUPERIOR HOME -- Because they are not taxed on the profit, homeowners have full use of their equity for a larger down payment, which combined with leverage, can dramatically increase their purchasing power for a better home. In addition to superior amenities, the new home can have greater potential for more rapid appreciation enhancing the wealth of the home owner.

EXAMPLE: The Smith's will be selling their home that they have owned for many years. If they sell outright, the Smith's will incur $30,000 of taxes on the large gain. However, because of the above provisions (old or new law), they will *zero out* taxes. The $30,000 in tax savings can be used for a down payment on a better home. As a 30% down payment, the $30,000 in tax savings (alone) give the Smith's an **additional** $100,000 worth of buying power ($30,000 divided by .30).

$100,000 DIFFERENCE! The $30,000 in *taxes saved*, combined with *leverage*, magnifies to a whooping $100,000 difference in ***additional*** buying power. If the new home appreciates at a modest 3% per annum in the next six years, the ***additional*** buying power of $100,000 would *compound* to almost $120,000. Because of the tax-free rollover (or exclusions), the Smith's have increased their wealth by $120,000.

***PLUS*:** Even better than the IRA, the Smith's also get to live in and enjoy their new investment.

NOW WITH A 1031 EXCHANGE SUPPOSE YOU OWN INVESTMENT PROPERTY THAT WILL SELL FOR $100,000

{And Has a *Substantial* Taxable Gain}

1. You can roll it over into another *superior* property (just as we did with the IRA and 1034 rollover).

2. If the new property costs $100,000 or more and you take out no cash*, you will have done a *total* 1031 tax-free rollover.

<u>*NOTE</u>: There are ways to take out tax-free cash in a tax-free 1031 exchange (see section VI).

3. You can use *leverage* and exchange *up* into more valuable property.

4. You can also exchange *down*. If the new property costs less than $100,000 you will be taxed on the down-difference (known as "boot"). You will have a part 1031 tax-free rollover and a part taxable sale (which is OK with the IRS, see section IV).

5. The properties in the 1031 rollover do <u>not</u> have to be of equal values.

6. You are not limited to just one relinquished property or just one replacement property (under section 1034, the homeowner is limited to *one* property at a time).

7. You can have *multiple* property transactions in one exchange.

8. Therefore you could rollover the $100,000 property and *diversify* into 2 or 3 new properties whose cost could be equal, greater or lesser than the $100,000 relinquished property.

9. Realtor commissions & most other closing costs reduce any taxable income in a 1031 rollover.

<u>TIP</u>: Another name for an "exchange", is a ***1031 TAX-FREE ROLLOVER.***

TAX RATES ON GAINS -- TAX ACT CHANGES & IMPACT

<u>Ordinary Income Tax Rates</u>: From January 1, 2003, and scheduled to expire December 31, 2010, the top four individual federal ordinary tax brackets are 25%, 28%, 33% and 35%. Prior to January 1, 2003, the income tax rates were - 15%, 28%, 31%, 36% and 39.6%.

Capital Gain Tax Rates: Effective May 6, 2003 there is a maximum federal long-term capital gain rate of 15%. There was a 20% federal long-term capital gain rate which was temporarily eliminated on May 5, 2003 and is scheduled to be reinstated January 1, 2009.

TAX TIP: To be eligible for the long-term capital gain, a property that is purchased must be held for **one year and one day.**

OVERALL, RATES ON TAXABLE GAINS ARE STILL HIGH. SOME ALERTS ABOUT THESE TAX RATE CHANGES:

ALERT 1: DEPRECIATION RECAPTURE -- For rental or business properties, there is also a maximum 25% rate on *all* depreciation allowed or allowable. Excess accelerated depreciation is still taxed as a high as 35%.

ALERT 2: ALTERNATIVE MINIMUM TAX (AMT) HIGHER RATES -- In theory the top capital gain rates (15%, 20%) is the same for both regular income tax and AMT (which has rates of 26 % & 28%). However, such a theory does not actually work out practically for many investors, for **the 20% rate on some capital gains can be erased under the AMT as well**. After certain amounts of income, the exemptions for AMT phase out. To the **extent that these exemptions are lost because of gains, the effective rate on gains becomes the AMT rate of 26%.**

ALERT 3: AMT PREFERENCE - DEDUCTION FOR STATE TAXES -- A gain will also incur **state income tax** liabilities. The deduction for any such state taxes is a preference item for AMT taxes. This too can trigger AMT.

CAUTION ON LOW TAX BRACKETS: Some people have the costly misconception that once they are in a lower tax bracket, it remains the same and does not increase even with a substantial gain. See the examples on the next page.

EXAMPLE: Assume Mr. & Mrs. Smith's taxable income is about $40,000 a year. If you check this income to the present tax rate schedule (filing jointly) their tax bracket is 15%. Now they think this, *"Even if I have a gain, I still am in the 15% ordinary tax bracket and so the capital gain is taxed at 10%".* WRONG! After a taxable income of $40,000, the Smith's are now in a 28% bracket. So, if they incur a gain of $60,000 from the sale of a single family rental (held more than a year), then the gain is taxed at *20%* (not 10%), leaving a $12,000 tax liability ($60,000 x 20%).

PLUS: DEPRECIATION RECAPTURE: For rental or business properties, there is also a maximum 25% rate on ALL depreciation allowed or *allowable*.

<u>EXAMPLE</u>: In the above example, assume the Smith's deducted $25,000 in depreciation during their ownership of the property. Of the total gain of $60,000, they would pay 25% on $25,000, and 20% on the remaining $35,000. Their total federal tax liability would be as follows:

Depreciation recapture --	25% x $25,000 =	$6,250
Long-term capital gain --	20% x $35,000 =	<u>7,000</u>
Total federal tax liability..............................		$13,250

PLUS: STATE & LOCAL TAXES: Depending on what state or locale the taxpayer is in, a gain could also result in additional state or local tax liabilities. In the above example, assume the Smith's state\local tax rate on gain is 5%. A $60,000 gain at 5%, results in an **additional $3,000 in taxes,** when added to the $13,250 equals a **"total" tax liability of $16,250.** ***<u>ALERT</u>*****:** The deduction of the state income taxes could also cause an additional tax from alternative minimum tax (AMT).

PLUS: ADDITIONAL TAXES FROM AN INCREASE IN AGI: A capital gain still increases Adjusted Gross Income (AGI) which increases the capital gain tax bracket. It also increases the amount of any social security includable in income. An increase in AGI could also cause additional tax liabilities from elimination or reduction of the following: Certain itemized deductions, casualty/theft losses, IRA deductions, personal exemptions, the $25,000 passive loss allowance for rental properties and the child care credit. All of the above simply means higher gain's taxes!

Total Rate: Therefore the gain on the sale of investment property results in *multiple* tax liabilities that can equate to a "total" tax bracket of 25%, 30%, 35% or even higher!

<u>TIP</u>: The most powerful way to <u>ZERO OUT</u> all of the above taxes on the sale of an investment property is a *1031 Tax-Free Exchange!*

TAXES ON GAINS ARE A ***<u>WEALTH DESTROYER</u>*** WITHOUT 1031

Without the Tax-Free benefits of Section 1031, the investment property owner would have to pay taxes on the realized gain which is the difference between the adjusted tax basis and net selling price of the property (see below). In rental properties, there are several factors that can substantiality (and *quickly*) increase taxable gain:

1. Appreciation (even modest appreciation over time).
2. Depreciation write-offs - reduce the tax basis of the property which has the same effect as appreciation - *increase* gain.
3. Any prior deferred gain on another rollover will also *increase* gain.
4. A section 108(c) exclusion from debt cancellation reduces basis and increases gain.
5. Deductible casualty losses taken also reduce basis and increase gain.

[ALERT: Items 2 to 5 will create what is known as "phantom income" which is taxable income but without receiving the corresponding cash. Consequently even without equity appreciation it is still possible to have a sizable phantom gain because of these non-cash taxable adjustments such as accumulated depreciation, a prior deferred gain, a 108(c) election, etc.]

Such gain on the sale of investment property generally results in *multiple* tax liabilities that can equate to a "total" tax bracket of 30%, 35% or even higher!

EXAMPLE OF COMPUTATION OF REALIZED GAIN

Below is an example of a gain computation on the sale of an investment property. (For a full blown discussion of 1031 gain computations, see section V). Example - The total selling price of your relinquished property is $ 80,000, less selling expenses of $6,000, leaves a *net* selling price of $74,000. You originally paid $50,000 (including closing costs), did no major capital improvements and deducted a total of $26,000 depreciation. There were no prior deferred gains. Therefore the adjusted tax basis is $24,000 ($50,000 less 26,000). Assume a *total* tax bracket of 30%. Your gain and tax liability are $50,000 and $15,000 respectively computed as follows:

1. NET SELLING PRICE........................... **= $ 74,000**

2. Less: ADJUSTED TAX BASIS................ = $ 24,000

3. Equals: REALIZED GAIN (line 1 less 3)... **= $ 50,000**

4. Times: *Total* Tax Rate................................ x 30% (.30)

5. Equals: TAXES ON GAIN (line 3 X 4)...... **= $ 15,000** (With*out* 1031)

"THE 1031 MONEY MACHINE"

Without 1031, the total taxes that would have to be paid are $15,000. These taxes are a problem! But we have a solution for you - *THE 1031 MONEY MACHINE.*
Paying taxes = LESS MONEY AND LESS MONEY = LESS WEALTH.

AS AN ASTUTE INVESTOR YOU ALWAYS TRY TO LEGALLY *ZERO-OUT* TAXES AND ACCUMULATE WEALTH BY COMBINING -- *LEGAL TAX AVOIDANCE, LEVERAGING* AND C*OMPOUNDING* VIA *THE 1031 MONEY MACHINE:*

> Because of the 1031 *rollover*, you *save the taxes* >
> The taxes saved along with *"leverage" increases your buying power*
> The increased buying power *compounds your wealth.*

<u>EXAMPLE OF THE 1031 MONEY MACHINE</u>: Referring to the above example:

> Because of a 1031 rollover you *save $15,000 in taxes >*

> The $15,000 (taxes saved) as a 20% down payment and using 80% "*leverage" creates an <u>additional</u> $75,000 worth of purchasing power*

$ 15,000 downpayment (20%)
<u>60,000</u> mortgage*leverage* (80%)
=**$75,000 ADDITIONAL buying power - which could mean:**

⇒ *Prime* location
⇒ *More* property - bigger & better
⇒ *More* houses (for SFH investors)
⇒ *More* apartments in an apartment building
⇒ *More* offices in an office building
⇒ *More* stores in a shopping center
⇒ *More* cash flow, More appreciation, More equity.....

AND THERE'S *MORE* - This $75,000 additional buying power, at a modest 6% growth rate in 10 years, would *compound to over $134,000* and in 20 years would *compound to over $240,000!*

THE BENEFITS OF 1031 ROLLOVERS ARE NOT JUST THE TAX DOLLARS THAT YOU SAVE, BUT ALSO THE ADDITIONAL WEALTH THAT CAN BE ATTAINED WITH THESE SAVED TAX DOLLARS!

"TAX DEFERRED" OR "TAX FREE"? -- THE POWER OF DEFERRAL VIA THE TIME VALUE OF MONEY = TAX-FREE!

A. You sell an investment property via a 1031 tax-free exchange and consequently save $20,000 in taxes. You can acquire another $100,000 worth of real estate with the $20,000 tax savings as a 20% down payment (with 80% leverage). If you are a savvy bargain hunter such as I am, that $100,000 of additional RE is really worth $140,000. Now look what you have accomplished -- Not only did you save the $20,000 in taxes, but also used the $20,000 to accumulate another $40,000, plus future growth. **The $40,000 is 2 times more than the $20,000 original tax savings.** And for those technicians out there is say a 1031 exchange is tax “deferred” and not “free”, you are *technically* correct, but *entrepreneurially* wrong! Technically, when a property is rolled over via 1031 the untaxed gain does not go away but stays with each rollover and would become taxable if the property were eventually sold outright. This is why the untaxed gain is called a "deferred gain". However, with the *power* of the time value of money, the tax savings can be reinvested to accumulate to an amount that is even greater than the original taxes saved, as demonstrated by this example.

B. INTEREST-FREE LOAN: Looking at it another way, the tax-deferred savings are a government loan with these *great* terms - NO interest, NO payments, you pay it back when you want (i.e. when you decide to dispose of the property in a taxable sale), and you may never have to pay back the loan (taxes), as per the next two paragraphs.

C. DEATH PERMANENTLY ELIMINATES GAIN: There is an old adage -*"Defer, Defer, Defer - Die!"* That is, by continuing to rollover property until death, the gain is no longer deferred but permanently eliminated. This is because under the tax law the death of the property owner will effectively cause an elimination of the taxable gain by a "step-up" of the tax basis to the fair market value of the property. As a result of employing section 1031, your heirs will have a much larger estate not only from the taxes saved but also from the years of compounded earnings on these taxes saved.

D. HOMEOWNER EXCLUSIONS CAN ALSO PERMANENTLY ELIMINATE DEFERRED GAIN: Suppose the exchange property is a rental house, which after a requisite time for rental, is converted to a principal residence for 2 years. The property owner can then use the $250,000/$500,000 exclusions to **permanently eliminate the deferred gain** (except for accumulated depreciation after May 7, 1997).

ANOTHER 1031 MISCONCEPTION - "LIKE KIND" IS NARROW?

NO WAY! It is true that one of the requirements for a qualifying 1031 rollover is that the properties must be “like-kind”. However, the term "like-kind" is not nearly as narrow as it sounds. 1031 rollovers apply to a *diversity* of small, large, residential, commercial, industrial, rural, resort-area or any combination of such investment properties. For example, raw land can be rolled over into income producing rental property or vice versa.

(The like-kind requirement is further discussed in section IV). Moreover *Several* properties can be disposed of or acquired via a 1031 rollover. There is a gourmet variety of diversified options and investment goals that will be illustrated through out this entire book.

THEN WHY ARE 1031’S LITTLE KNOWN & UNDERUTILIZED?

- Lack of knowledge
- Lack of training and education in the field
- Fear of the unknown

- Unfounded fear of the IRS
- Misconceptions or *"old wives' tales"* about Exchanges
- Unconcerned or inept Accountants, Attorneys, Realtors, etc.

NONE of the above are good reasons and therefore should not stop you from enhancing your wealth. 1031 Tax-Free Exchanges are vehicles of wealth accumulation which are *legal*, if you simply follow the IRS safe harbor regulations (see section IV).

WHEN *NOT* TO USE SECTION 1031

As with any other planning tool, 1031 rollovers should be appropriately employed in accordance with the entrepreneur's objectives. Consider the following scenarios:

1. IF THE PROPERTY WILL BE SOLD AT A LOSS. A realized loss will incur on the sale of investment or business-use RE when the adjusted tax basis exceeds the net selling price. Under Section 1031 losses are deferred as well as gains [IRC1031(a)(1)]. Therefore to recognize and deduct the loss, you should have a clear-cut *sale* and not a 1031 exchange.

2. WHERE ONLY A NOMINAL AMOUNT OF TAXES ARE DUE. What is a nominal amount of taxes? This is subjective to the individual situation. I've seen individuals employ 1031 even only with $2000 or $3000 dollars in "net tax savings" ("net tax savings" being the total taxes saved less the additional costs to do the exchange). It is true $2000 or $3000 of immediate net tax saving won't make you rich but can pay for a vacation, high school or community college tuition, be enough for an IRA or Keogh contribution. Of course any reduction in depreciation deductions (because of a possibly lower basis on the replacement property) should also be considered here.

> **BUT DON'T FORGET THE TIME VALUE OF MONEY!** Immediate tax savings via 1031 as opposed to deferred tax savings via higher depreciation deductions without 1031, are still more beneficial to you. Moreover by exchanging up in value, you can have an increased depreciation basis in the replacement property. Moreover, "basis" doesn't make you money like MONEY itself.

3. WHERE THERE ARE LOSS CARRYOVERS SUCH AS PASSIVE LOSS OR NET OPERATING LOSS (NOL) CARRYOVERS

3. WHERE THERE ARE LOSS CARRYOVERS SUCH AS PASSIVE LOSS OR NET OPERATING LOSS (NOL) CARRYOVERS. There may be enough of such carryovers to offset any gains to a point where a 1031 exchange is not worthwhile.

> WATCH THIS: You can combine loss carryovers and 1031 rollovers. For Example, suppose on the sale of investment real estate, you have a total realized gain of $150,000 and a $50,000 loss carryover. After applying the $50,000 loss carryover, there is still a significant gain of $100,000 which can be avoided by a 1031 rollover.

TAX POINTER: Even with loss carryovers, it still may benefit you to do a 1031 exchange. For a further discussion, see Albert Aiello's *Real Estate Investor's Goldmine Of Tax Strategies*, Section 25, Part B.

4. WHERE THE INVESTOR IS LIQUIDATING AND WANTS OUT OF RE ????

Here liquidating-minded property owners should be asked these 2 questions:

(1) "Upon liquidating, what will you do with the *tax-drained* cash ?"

The probable answer to this first question is that they will somehow spend it, squander it, or put it in a 3% bank CD. Furthermore the 3% CD on an *after-tax-drain* basis is really an effective ("poverty") yield of less than 2%! By prudently employing the wealth accumulation benefits of section 1031, the investor can create a forced savings into real estate which can generate a superior yield, especially on an after-tax basis.

(2) "What do you really want to avoid - *Real Estate* or *Tenant Management*?"

If the investor wants to avoid management then they should consider liquidating out of *management* and NOT out of the hand that fed them - *Real Estate*. By staying in real estate, they can take advantage of the wealth accumulation benefits of 1031. There are a number of creative ways that are discussed in this book to stay in RE and reduce or eliminate management (especially in sections VIII-9,10, & IX).

Moreover, anyone who wants to get out of real estate is nuts!

Why? See the next section.

III. *WHY* REAL ESTATE?

AN IMPERATIVE PART OF BEING A 1031 EXCHANGE ENTREPRENEUR IS THAT YOU HAVE THE *BELIEF* THAT REAL ESTATE IS A *SUPERIOR* INVESTMENT

"But Real Estate Is A Pain On The Neck?" - And So Is Life!

The majority of people who say this go throughout life with a dead-end job with all kinds of hassles -- fighting traffic everyday, putting up with the "boss", disagreeable cohorts, complaining customers, the "rat race"... and all for mere *taxable* wages.

* With relatively little more effort, one real estate investment could probably make these people MORE MONEY THAN 5 OR 10 YEARS OF *WORKING.*

* With real estate there is the power of *"Leverage"* - using *other* people's money ("OPM") to control more value and attain more wealth.

* You can profit from real estate WITHOUT EVER OWNING IT such as through *"Options"* and other creative strategies (see section VIII-16).

* You have more CONTROL over real estate. You can make it go up in value through your own efforts and not have to depend on inflation.

* Your TENANTS PAY THE PROPERTY'S MORTGAGE payments. At the end of the mortgage you can end up owning the property free & clear. You can amass valuable equity even <u>without appreciation</u>. Any appreciation is an *added bonus*.

* *BIG* TAX WRITE-OFFS* can generate additional cash flow. Even if you are subject to the passive loss limitations, any taxable income can be sheltered and the unused losses can offset future taxable gains (and **don't forget *1031 Magic*!**)

*For more about this, refer to my *Real Estate Investor's Goldmine of Tax Strategies*.

* Many people make the mistake of avoiding real estate because of *tenant related problems*. I have found that most problems with tenants result from two reasons:

(1) Something the property owner did wrong, or

(2) Something the owner did not do at all (and should have done something).

Property *owners* (not tenants) cause tenant problems.

* Properly screening tenants, holding on to good tenants, dealing with problems and doing the right things that lead to profit all take KNOWLEDGE which can eliminate most tenant problems.

Today we are fortunate to have a wealth of excellent publications on how to buy, finance and *manage* real estate. One of the most powerful sources of information is "MR Landlord" which is a superb monthly newsletter on the creative marketing & management of residential properties. I believe it to be the one of the best in the country. You should definitely subscribe to it. Buy the back issues; they are full of practical gems. They also have a library of many other excellent real estate publications. Call ISU at 1-888-544-4636. There are many other sources, including those on commercial properties. Books stores are full of them.

PLUS: BECAUSE REAL ESTATE IS SO DIVERSE IN NATURE, YOU CAN ALSO OWN PROPERTY WITH LITTLE OR NO MANAGEMENT RESPONSIBILITY

Examples are:

- TRIPLE NET LEASE PROPERTY (see Section VIII-10).

- YOUR *DREAM* HOME IN THAT *DREAM* LOCATION TAX-FREE (see Section IX).

- OTHER TYPES OF PROPERTY THAT CALL FOR LESS MANAGEMENT ARE: Garages, mini-storage units, parking lots, land, and single family homes (that are structured with creative leases).

- OTHER WAYS TO REDUCE MANAGEMENT ARE: Engage a competent management company to manage the property or use a partner (perhaps a family member)

{The above are further discussed throughout the book}.

THE SOURCES OF EXCELLENT BUYS ARE MANY:

- Newspaper ads, legal publications, etc.
- Multiple listing books (expired listings)
- Accountants & Attorneys (often have clients who are involved with foreclosure bankruptcy, estates, divorces, etc.)
- Lenders - (REO'S or Real Estate Owned)
- Public records at the county court house
- "Bird Dogs" (finders of good deals)
- Property management companies
- Foreclosures\ Sheriff sales - RTC, VA, HUD
- Investor & apartment owner associations
- Distressed Builders (and other distressed sellers)
- Housing offices of large companies such as (IBM, Hertz, RCA)
- IRS (contact the "R.O." or Revenue Officer)
- Tax assessor's office
- Friends, acquaintances, associates, etc., are just some of the many sources of good buys.

Here are some other investing tips....

USE A REAL ESTATE AGENTS/BUYER'S REPRESENTATIVE -- Because of their extensive access and contacts, Realtors are one of the best (and quickest) sources of good buys. Traditionally they represent the seller. However under recently enacted agency laws the agent can represent *you* as a buyer's agent. This means that their loyalty and fiduciary responsibility is to you first and not to the seller. Therefore they can inform you of *valuable* information about the market, the property, the seller and other important data. They would otherwise not be permitted do this if they were representing the seller. This is a valuable resource that I highly recommend. It's a time saver and generally does not cost you anymore.

CALL ON *RENT* ADS - (Yes, I said "Rent" ads). This is a very overlooked source of excellent buys. Someone with a vacant property has a PROBLEM and sometimes to eliminate the problem they really want to sell (*fast*) at an attractive price or terms.

RUN YOUR OWN REAL ESTATE WANTED AD -- Examples are: *"I buy properties for cash", "I buy properties with a quick closing",* or something similar to attract distressed sellers. (This will save you a lot of time and will get you results).

<u>NOTE THIS</u>: BUYING REPLACEMENT PROPERTY IN A 1031 EXCHANGE HAS TWO OTHER IMPORTANT ADVANTAGES:

1. WITH THE TAX SAVINGS YOU ALREADY HAVE A *BUILT-IN DISCOUNT*

For example, assume you buy a replacement property for $100,000 as a part of a tax-free rollover. As a result you save $20,000 in a taxes. In effect you have really paid $80,000 for the new replacement property (the $100,000 purchase price less the $20,000 tax savings). Putting it another way, had you *not* done the 1031 rollover, paid the $20,000 in taxes, and still purchased the property for $100,000, you would have really paid $120,000 for it (the $100,000 purchase price plus the $20,000 tax drain)

2. MOST EXCHANGOR'S ARE STRONG CASH BUYERS

Prudent investors who elect to do a 1031 tax-free exchange often have substantial equity in their property. Moreover, whatever the equity is, it is further *increased* by the tax savings from the exchange. The more equity you have, the more cash buying power you have. Stronger cash buying power gives you a much better negotiating advantage in seeking out good buys from the above mentioned sources. Where additional financing is required, a substantial cash position greatly increases your ability to obtain financing so you could *leverage* into higher yielding property. This is the "1031 Money Machine".

What better combination -- ***REAL ESTATE* and *THE 1031 MONEY MACHINE*!**

IV. AN OVERVIEW OF THE IRS REQUIREMENTS

To have a qualifying exchange ALL of the following requirements must be met:

1. QUALIFIED INTERMEDIARY ("QI") - The IRS requires that ALL exchanges (delayed <u>and</u> simultaneous) use an independent, unrelated "qualified intermediary", IRS Regulations 1.1031(k)-1(g)(4) and 1.1031(b)-2.

(1) The QI is a "middleman" that will acquire and transfer the relinquished and replacement properties to *create the "exchange"*. These acquisitions and transfers are generally accomplished by exchange documents and not by additional deeds. In other words, there is no need for additional deed transfers (in most exchanges). Just the usual types of deeds can be prepared as you would with any other settlement. In fact the QI does not even have to be at settlement.

(2) The QI is a "safe harbor" in the IRS regulations. This safe harbor function is typically done by a private service company that is retained by the property owner doing the exchange. The QI prepares the necessary documentation and forms to create the "exchange" so that it qualifies under IRS regulations. At the present time there is no licensing requirements for QI's and most title agencies are not QI's.

(3) The fees of QI's vary. Generally, in comparison to the wealth accumulation benefits of 1031's they are extremely reasonable. For example, for a residential exchange a typical fee may be a $1000 to $1500. Let's say a fee of $1500 to save taxes of $15,000 equates to a ***1000% return!*** The fees for commercial exchanges would be higher but the results even be more staggering.

(4) A "limited service" QI will only prepare the documentation and act as escrow for the 1031 exchange. They will not help you to structure your exchange. They do not advise you on the tax law or accounting aspects of your exchange.

(5) A "full service" QI does exchanges *full time* and will not only prepare the essential documents, but also will counsel and guide you on all of the technical aspects of your 1031 rollover. This is an important part of the service because most tax professionals are not *1031 Exchange Specialists*.

[<u>**TAX TIP**</u>**:** You should engage a *full service Qualified Intermediary* who will be readily available to render you technical advice throughout your 1031 rollover. Moreover, you should engage the QI well in *advance* of any closings. In the back of this section are *what questions* to ask of a prospective QI].

ALERT ON THE INCORRECT WAY TO STRUCTURE A 1031 EXCHANGE:

Since their inception back in the 1930's, *ALL* MULTI-PARTY EXCHANGES REQUIRED THE USE OF AN INTERMEDIARY. In the past, many times the intermediary (or "accommodation party") would be the buyer of the relinquished property in what was known as an "ABC Exchange". Sometimes the seller of the replacement property would act as intermediary (or accommodation party) in what was known as an "ACB Exchange". The ABC and ACB Exchanges are <u>not</u> permitted by the IRS safe harbor regulations [Regulations 1.1031(k)(1)(g)(4) and 1.1031(b)(2)]. If you want to have the blessings of the IRS, you must use an outside Qualified Intermediary on <u>**All**</u> exchanges - whether they be simultaneous, 2-Party, or deferred exchanges. Otherwise, the IRS will most likely disallow your exchange.

USING THE BUYER AS INTERMEDIARY COULD ALSO BLOW OUT YOUR DEAL!

1031 exchanges save substantial amounts of taxes. In the ABC exchange, accommodation buyers know this and therefore many often want to be compensated well, such as with a substantial reduction in selling price. Moreover, the ABC exchange is more awkward to do and more time-consuming at settlement. As a result heated disputes (even physical) often arise. Many times transactions fall apart! Using an outside *Qualified Intermediary* (the "QI") eliminates these problems. Besides being in accord with the IRS, using a QI has other advantages:

* LESS TRANSFER FEES - With the ABC type of exchange there is the need for the buyer, as the accommodation party, to enter into deed twice. The result is duplicate transfer fees. When you engage a *QI,* there is no need to enter into deed twice (in most exchanges). There can be one deed ("direct deeding"). This means - less transfer fees, less time, less hassle... *smoother* settlements!

* VALUABLE PROFESSIONAL ADVICE - 1031 rollovers are excellent vehicles of wealth accumulation. However they are a very specialized field that call for competent expertise. If not structured properly, a 1031 rollover can be disallowed by the IRS and turn into a financial disaster! *Full service* QI's *also* counsel you on the technical aspects of your exchange to help ensure that your exchange qualifies under *current* IRS regulations.

2. “QUALIFIED ESCROW ACCOUNT"

(1) The qualified escrow account is also a “safe harbor” in the IRS regulations. When you settle on your property you must not receive the sales proceeds - such funds must be held in a “qualified escrow account" (with a qualified escrow agent) for the purpose of acquiring replacement property. The 1031 escrow is required in a delayed* exchange.

> {*Note: Simultaneous exchanges will not require escrow but do require a *qualified intermediary,* Regulation 1.1031(b)-2.}.

(2) The escrow agent can be a company separate from the intermediary (QI) such as a local title company or bank, or it can be the QI.

> NOTE: “ESCROW” and “INTERMEDIARY” are two separate safe harbors. “ESCROW” holds the net sales proceeds from the closing of the relinquished property. “INTERMEDIARY” acts as middleman creating the “exchange” with the proper documentation. Both functions can be done by two separate companies or by one company.

(3) Once the funds are in the escrow account, you must not have the actual or constructive right to receive such funds. {IRS regulation 1.1031(k)-1(g)(6)}
The account must be in the name and ID number of the escrow agent. The escrow account can only pay for expenditures related to the acquisition of replacement property such as earnest money deposits, commissions, closing costs and the funds needed at settlement for the replacement property. It cannot make distributions directly to the exchangor or it cannot pay for personal expenses of the exchangor.

(4) The escrow account cannot be used as security or collateral for a loan. However it *can be* used as an asset on a financial statement or mortgage application.

(5) You can keep any interest on the escrowed funds provided it is restricted in the same manner as the corpus.

> **RECOMMENDATION:** It is imperative that your funds be protected from fraud or misuse. The company that holds the funds should be bonded, insured, funded and have a well established, pristine reputation. They should also be a duly authorized corporation where there is *continuity of life* and the incapacity of an officer or stockholder will not erase the company’s existence, which in turn could cause the disqualification of the 1031 and the loss of your escrowed funds. Carefully check them out, and do not be afraid to ask for references.

3. BOTH THE QI AND ESCROW AGENT MUST BE "QUALIFIED"

"Qualified" means that the intermediary and the escrow agent can<u>not</u> be "agents" of you, the exchangor. Such agents (or "disqualified persons") would be you, your employee, attorney, accountant, mortgage banker, real estate agent or broker. Included here are certain related parties - lineal descendants [under IRC 267(b)] such as parents, grandparents, children, brothers, sisters as well as more than 10% entities that you own (such as a corporation or partnership, IRC 707(b)]). All of these are known as "disqualified persons" and if you use them for your QI or escrow agent, your exchange will be disqualified. {IRS regulation 1.1031(k)-1(g)(4) & (k)-1(k)}. The QI and escrow agents must be *independent & unrelated* parties.

> <u>NOTE</u>: While the QI is not allowed to act as your accountant, attorney, etc., they are permitted to render *1031* tax advice related to your exchange. This is why it is important to use a full service QI who does render such advice.

A TITLE COMPANY *CAN* BE THE ESCROW AGENT HOLDING THE FUNDS FROM THE SETTLEMENT OF THE RELINQUISHED PROPERTY

> **ALERT:** Provided that you, your employee, your attorney, accountant, mortgage banker, Realtor or any lineal descendants do not own more than 10% of the company, then the title company can be the escrow agent (provided these same rules are met).

<u>CAUTION! TRUE STORY</u>: In an exchange I did a number of years ago, the client's attorney suggested that we use the title company doing the closings to escrow the funds from the closing of the relinquished property. But, through our *1031 Pre-planning Diagnostic Questionnaire*, I knew that the attorney also owned the title company. Because the attorney was "agent" to the exchangor and owned more than 10% of the title company, the title company could <u>not</u> be the escrow agent (or the QI). This is so even though this was the first time the attorney represented the client. The attorney was representing them as legal advisor, not as a 1031 consultant. As a solution we used another unrelated title company as escrow agent. We then had a *qualifying* 1031 rollover.

> **<u>1031 TAX TIP</u>:** Again, make certain that you use a *full service* intermediary company that thoroughly knows 1031 rollovers and does a *pre-planning* review to ensure compliance to the IRS regulations. Engage the QI well in *advance* of any closings, even before you have a buyer. Do it right!

4. THE PROPER DOCUMENTATION MUST BE USED - Such documentation must contain the "magic language" that conforms to *current* IRS regulations. The QI will prepare the documents, the most important being the following:

◊ THE 1031 *EXCHANGE AGREEMENT*

This nuclear agreement is between the exchangor and the QI. It summarizes the QI’s conduit role as acquiring and transferring the relinquished & replacement properties via the 1031 exchange. It also contains intent to "Exchange", assignments of the exchangor’s rights, intent to comply with time restrictions, intent to maintain continued investment in like-kind property, intent of exchangor *not* to have the actual or constructive right to cash (or other non-qualifying property) in accordance with IRS reg. 1.1031(k)-1(g)(6). In short the agreement contains the *“magic language”* in accordance with the most current 1031 exchange requirements including the safe harbor regulations (1.1031(k)-1).

◊ THE 1031 *EXCHANGE ESCROW AGREEMENT*

This agreement is between the QI and escrow agent. It is only necessary if the escrow agent is not the QI but a separate company apart from the QI (such as a title company or bank). This document too must contain the *“magic language”* in accordance with the most current 1031 exchange requirements including the safe harbor regulations (1.1031(k)-1). Especially important is the intent of the exchangor *not* to have the actual or constructive right to cash (or other non-qualifying property) in accordance with IRS reg. 1.1031(k)-1(g)(6).

◊ THE *1031 EXCHANGE ADDENDUM AND ASSIGNMENT* to The Sales Agreement for the R*elinquished Property*

The parties to this agreement are the QI, exchangor, and the *buyer*. It can be incorporated directly into the sales agreement or be an addendum to the agreement. The document contains similar content to the above 1031 exchange agreement (but on a more modified basis). It’s most important provision is the written assignment of the exchangor's rights in the relinquished property agreement to the QI. As with the exchange agreement it contains the *“magic language”* in accordance with the most current 1031 exchange requirements including the safe harbor regulations of 1.1031(k)-1.

◊ THE *1031 EXCHANGE ADDENDUM AND ASSIGNMENT* to the Purchase Agreement for the *Replacement Property*

The parties to this agreement are the QI, exchangor, and the *seller*. This document contains similar content to the above exchange addendum to the relinquished property. It too includes the assignment of the exchangor's rights in the purchase agreement to the QI along with the essential "magic language".

[NOTE: What if the buyer or seller does not want to sign the above addendum's ? - This is discussed below.]

◊ *45 DAY IDENTIFICATION LETTER* - sent by the exchangor to the QI (discussed later in this section)

◊ *1031 EXCHANGE SETTLEMENT SHEET* - Relinquished Property

This would be a settlement sheet but with "exchange" modifications to create a *clear* IRS trail that a 1031 exchange has occurred. The parties to the settlement sheet would be the exchangor, the buyer and the QI.

◊ *1031 EXCHANGE SETTLEMENT SHEET* - Replacement Property

Same as the above, except instead of the buyer as a party there would be the seller of the replacement property.

RECOMMENDATION: IRS agents are used to seeing *standard* HUD'1's. Anything that is different could throw them off. Therefore as part of creating a clear IRS trail of a 1031 exchange, both of the above settlement sheets should be *standard* HUD-1 forms. (In most cases RESPA requires them anyway).

WHAT IF THE BUYER OR SELLER REFUSES TO SIGN THE ABOVE ADDENDUM'S?

Two of the above exchange documents are the "*1031 EXCHANGE ADDENDUM AND ASSIGNMENT* to The Sales Agreement for the *Relinquished Property*" and "THE *1031 EXCHANGE ADDENDUM AND ASSIGNMENT* to the Purchase Agreement for the *Replacement Property".* Besides the exchangor and QI, they require the signature of the buyer (on the *relinquished* property) and the seller (on the *replacement* property). But what happens if the buyer (or seller) refuses to sign? It does happen occasionally.

Under the IRS regulations this should not hurt the 1031 rollover. Ideally, ALL parties, buyers, sellers and the QI should sign the above addendum's. First of all these are "bare" or "paper" assignments only for the purpose of the 1031. They are not a novation or complete substitution of a new party. All of the parties, rights, warranties and obligations of the original agreements remain in place. All other parties are held harmless. However if the buyer (or seller) is uncooperative about signing, the requirements of regulation 1.1031(k)-1 should still be met if the buyer (or seller) is <u>notified in writing</u> of the assignment to the QI on or before the closing of the exchange property (underlined emphasis added). Therefore the assignment can be done in a letter form and sent or given to them.

<u>RECOMMENDATION</u>: The above letter notification should be timely sent before the respective closing, certified mail with a return receipt. You or your representative should also hand it to the buyer (or seller) at the settlement.

OTHER ESSENTIAL DOCUMENTS (not usually prepared by the QI):

IRS REPORTING FORM 1099S - On form 1099S is a box for the insertion of what is called the *"gross proceeds"*. In a 1031 exchange transaction the amount inserted here should be zero ("0"). The box at the bottom should also be checked that the *transferor* (the exchangor) will *"receive property or services as part of the consideration"* (as this is a 1031 exchange).The exchangor's name and federal ID number are also to be inserted. If the QI is a corporation (which they should be), then the QI does <u>not</u> receive a 1099. The 1099S is generally prepared by the title company or closing attorney for the relinquished property.

IRS INCOME TAX REPORTING FORMS - Forms 8824, 4797, Schedule D. These are generally prepared by the exchangor's tax advisor.

<u>NOTE ON 1031 TAX REPORTING FORMS</u>: The proper completion of these forms require consummate tax expertise with careful attention to details. Many tax advisors do not know how to prepare them properly. Moreover IRS instructions are very confusing and misleading. My book, *1031 Exchanges - Financial Analysis & Strategies*, gives an easy step-by-step approach for their proper completion with backup forms. Both filled-in and blank forms are included. It also covers many other important technical areas of exchanges not discussed in this book. To order, call us at 1-888-544-4636 or 1-937-9207 or see the back of this book.

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NEW: For updated 1031 exchange documentation, order our latest package, *Turbo-Exchange*, the first do-it-yourself 1031 exchanges forms & software kit To order, call us at 1-888-544-4636 or 1-215-937-9207.

5. TWO TIME REQUIREMENTS - Starting from the first closing of your relinquished property, you must adhere to two sets of time requirements:

(1) **45 days** to identify replacement property (see 5A toward the bottom of this page)

(2) **180 days*** to close on identified replacement property. (see Alert 1 below)

Both run *parallel* from the *closing date* of the relinquished property. Therefore, the 45 days comes out of the 180 days. Both time requirements must be met for a qualifying 1031; there are NO statutory extensions to these deadlines. IRC 1031(a)(3); Reg. 1.1031(k)-1(b)(2).

***ALERT 1**: It is the *shorter* of 180 days or the due date (including extensions) of the taxpayer's tax return.[Regulation 1.1031(k)-1(b)(2)(ii)]. For example, an individual taxpayer closes on their relinquished property December 18, 1997. From this date, 180 days is June 16, 1998. However, the taxpayer only has until April 15, 1998 to acquire identified replacement property, unless they file a 4-month extension by April 15, 1998. In one case, the taxpayer filed their tax return by the April 15th due date (no extension), but acquired replacement property after that due date. Even though the property was acquired before the 180 day time limit, the exchange did not qualify because an extension was not filed.(*O.E. Christensen, TC memo 1996-254*).

> **TIP**: If the settlement date of your relinquished property is between October 15 and December 31, you may have to file for an extension of your tax return to have the full 180 days. Check with your tax advisor for the proper and timely filing of any extensions.

ALERT 2: The number of days in each period (180 or 45 days) is not extended if the last day of the period falls on a Saturday, Sunday or legal holiday. You must report the 45-day and 180-day dates when you file your tax return on IRS form 8824.

5A. THE 45-DAY IDENTIFICATION OF REPLACEMENT PROPERTIES

a) The ID Is done by the exchangor sending a letter to the Q.I. listing the specific addresses of the identified replacement properties and by *signing* the letter.

b) The letter can be mailed, faxed or delivered to the Q.I. and is to be postmarked no later than midnight of the 45th day following the closing of the relinquished property. You should obtain *proof* of sending (e.g. - Fed Ex receipt).

c) Limitation as to *No.* of replacement properties - You can identify up to 3 properties regardless of their value with no problem. Depending on the sales price of the relinquished property it is possible go *above* 3 properties under a special rule known as the *"200% rule"* (see the next page).

d) You do not have to be obligated to acquire all 3 replacement properties but you must acquire at least one of them within the 180-day exchange period. For example, In a letter to the Q.I., Ms. Investor timely identifies properties A, B, and C and ends up acquiring property F..... the *"F"* stands for *F*lunk! She does *not* qualify for the 1031 because she did not acquire A, B, or C.

e) TWO EXCEPTIONS TO (d) ABOVE:

1. Any replacement property closed on within the 45 days is deemed to be *automatically identified*. In the above example, if "F" were closed on within the 45 days then it would have qualified for the 1031 rollover.

2. Revocation - You can revoke prior identifications. It must be done in a letter to the Q.I. and within the same 45 days. In the above example, if A or B or C were timely revoked and replaced with F then it would have qualified for the 1031.

IDENTIFYING MORE THAN 3 PROPERTIES (200% VALUE RULE):

Within the 45 days, you can identify more than 3 properties, but their combined fair market value must not exceed double (200%) of the selling price (fair market value) of your relinquished property (the property you are selling via the exchange).

EXAMPLE: If the selling price of your relinquished property is $100,000, then 200% or double this amount is $200,000. If you identify 3 properties (A, B & C) whose combined value is $400,000, you are OK because you only identified 3 properties. (Under the 3-property rule where values are not relevant). However, had you identified 4 properties (A, B, C & F) whose combined value is $400,000, then you would not qualify for the exchange, because you flunk the 3-property rule (you are over 3 properties) and you flunk the 200% rule (at $400,000 you are over $200,000 which is 200% of the selling price of your relinquished property).

ALERT: Although the regulations are not a 100% clear on this, it would appear safe (and prudent) to assume that each separately deeded property is a single parcel for purposes of these rules. For example, Condo A and Condo B are right next door to each other and they are separately deeded. They still are two separate properties. The same would appear to hold for two separately deeded adjoining parcels of land*.

[*PLANNING TIP: If the same owner owns both parcels, you may be able to have your real estate attorney do an assemblage and merge the two deeds into one. Now you have two parcels, but *one* property for the purposes of the 45 ID].

RECOMMENDATION: Because values can be arbitrary, you generally should try to stay within the 3-property rule.

6. "LIKE-KIND" - Both the relinquished and replacement properties must be "like-kind". This is generally a very broad category with many diverse options. Just about any type of rental, business-use or investment *real estate* would qualify. IRC 1031(a)(1), Regulation 1.1031(a)-l(b) and Regulation 1.1031(a)-l(c).

EXAMPLES OF LIKE-KIND REAL ESTATE CATEGORIES

- In the *Residential* Sector - Rental houses, rental condos and coops, duplexes, triplexes, quadraplexes, apartment buildings.

- In the *Commercial* Sector - Shopping centers, retail stores, office buildings, motels, hotels, B&B's, parking lots, ranches, farms, trailer parks, storage facilities, garages.

- In the *Industrial* Sector - Warehouses, plants, factories, storage facilities, etc.

Plus any other type of *Rental*, *Business-Use* or *Investment* real estate, considered to be *real* property under local law:

A. *Rental* property would be residential, commercial or industrial property that you rent out to others.

B. *Business-use* property is property you would own and use in your own business, such as an office building for your own RE company or a plant for your manufacturing operation.

C. *Investment* real estate is property you hold for passive appreciation such as raw land (YES, land also qualifies, IRS Reg. 1.1031(a)-1(b) and (c); Rev Ruling 72-515}.

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EVEN THE FOLLOWING QUALIFY FOR LIKE-KIND:

* A lease of 30 years or more [Reg. 1.103l(a)-l(c)]
* A ground lease [Reg. 1.103l(a)-l(c)]
* A partial tenant-in-common interest in real property [IRS Revenue Ruling 73-476]
* Easements; Mineral & water rights [IRS Revenue Ruling 72-549].
* Improvements to be constructed [Reg. 1.1031(k)-1(e)]
* Certain time shares [IRC 1031(a)(1)]

(Note: All of the above are covered in separate sections throughout the book)

WATCH THIS - **YOU CAN GO *"ROUND-ROUND, GET AROUND"!***

Via a 1031 exchange you can "rollover" the above types of like-kind real estate any which way you want:

⇒ From *residential* to *commercial* or vice versa
⇒ From *residential* to *industrial* or vice versa
⇒ From *commercial* to *industrial* or vice versa
⇒ You can rollover a *rental house* into an *office building* or vice versa.
⇒ You can rollover a *rental condo* into a *shopping center* or vice versa.
⇒ You can rollover a *shopping center* into an *apartment building* or vice versa.
⇒ You can rollover *farm land* into a *rental house* or vice versa.
⇒ You can rollover *commercial business-use* property into *land* or vice versa
⇒ You can rollover *land* into *income producing rental* property or vice versa
⇒ You can rollover a *30-year lease* into *income producing rental* property or vs.
⇒ You can rollover an *easement* into *income producing rental* property.
⇒ You can rollover an *apartment building* into *ground leases* or vice versa
⇒ You can rollover a *part tenant-in-common interest* into a *full fee simple ownership* or vice versa
⇒ You can rollover *commercial business-use* property into *residential rental* property or vice versa
⇒ You can rollover *several* properties into *one* property or vs. You are not limited to just one property. Several properties can be exchanged in a 1031 transaction.
⇒ You can rollover to and from any one of these types of properties in *any location within the U.S.*

Many creative examples will be given through out this book.

RELATED PARTIES - You can do an exchange with a related party [IRC 267(b)] provided the property is held for two years (there is a holding requirement anyway).

<u>NON</u> LIKE-KIND REAL ESTATE - Under IRC 1031(a)(2) the following are NOT like-kind and therefore would not qualify for a 1031 rollover:

- Inventory or other property held primarily for sale, IRC 1031(a)(2)(A) (see next requirement)
- Corporate stock, IRC 1031(a)(2)(B) (See note C on page 33)
- Bonds, securities, REITS, notes, mortgages, IRC 1031(a)(2)(B) and (C)
- A partnership *interest*. IRC 1031(a)(2)(D) (See note A on page 32)
- Certificates of Trust or Beneficial Interests, IRC 1031(a)(2)(E)

OTHER *NON*-LIKE KIND PROPERTY:

- Real property for personal property (See note B on the next page)

- Exchanges between certain related parties under IRC 267(b) where one of the exchange properties is subsequently transferred *before* the end of 2 years [IRC 1031(f)]. (However if the property is held for two years then it is like-kind. Therefore you can do an exchange with a related party if the 2-year holding rule is met).

- Certain intangible assets such as going concern value and goodwill do not qualify {Reg.1.1031(a)-2(c)(2).(However certain copyrights can be like-kind. Patents, franchises, tradenames, trademarks and licenses may qualify depending on the nature or character of underlying the rights involved)

- Real property located in the U.S. and real property outside the U.S. IRC 1031(h) (see note D on the next page).

NOTES TO THE ABOVE:

A) PARTNERSHIP INTEREST - A partnership *interest* does *not* qualify. IRC 1031(a)(2)(D). However as an "entity" the partnership *itself* may qualify for 1031 provided all other requirements are met including the *same* partnership <u>entity</u> *continuing* to *hold* the replacement property as like-kind investment property.

<u>PARTNERSHIP SPLIT-UPS</u>: Many times in a partnership situation, you have some partners who want to do a 1031, while the others want to cash out and not do a 1031*. In this scenario the usual strategy is to dissolve the partnership and create a "co-tenancy" ownership. The qualifying co-tenants can then do the 1031 rollover while the other co-owners can just sell for cash and pay the taxes. (*As we will learn in Section VI, you can do *both* a 1031 tax-free exchange and cash out). The methods for converting a partnership to co-tenants are beyond the scope of this publication. (For high quality 1031 exchange advice call 1-800-351-1031).

[<u>NOTE</u>: Many co-owners of investment properties will say they are in a "partnership" when in fact they are not as they have not filed IRS Forms 1065 and the related K-1's (which are partnership tax forms). They use the word "partnership" in a generic business sense instead of the tax technical meaning. Accordingly, they are really tenants-in-common, which is what we prefer. In this preferred situation they did not file partnership tax forms but each co-tenant individually reported his or her respective share of rents and property expenses on page 1 of IRS form Schedule E of their own 1040. Of course, you want to double check this with your tax advisor. If so, do the exchange as co-tenants!]

B) PERSONAL PROPERTY - Where the 1031 rollover includes real property, such realty often contains certain "personal property" such as appliances, furniture, etc. Here the personal property will be considered non like-kind "boot" which will not disqualify the exchange, but may cause it to be partially taxable.

Tax Planning Tips To Avoid Taxability With Personal Property:

(1) Do not list any significant personal property in the agreements or settlement sheets.

(2) Have a parallel rollover of realty for realty and like-kind personal property for personal property. The entire transaction could then be like-kind.

(3) Acquire the replacement personal property *separate* from the real property exchange with funds apart from the exchange.

(These planning strategies are covered more in detail in my book *1031 Exchanges - Financial Analysis & Strategies*).

C) STOCK - Shares of stock in a corporation will not qualify for 1031 even if the sole asset of the corporation is qualifying real estate. However, as an "entity" the corporation, *itself*, can qualify for 1031 (provided the other requirements are met).

D) FOREIGN PROPERTY - Real property located in the U.S. and real property outside the U.S. do not qualify, IRC 1031(h). However, *foreign* real estate for *foreign* real estate and *U.S*. real estate for *U.S.* real estate is like-kind. For example, you cannot rollover property from the U.S. to Canada (or vice versa). However, you can rollover property from Mexico to Canada (*foreign for foreign*). Of course you can rollover anywhere in the U.S*.

{*Note: It appears that the "U.S." is the 50 United States (including the District of Columbia) and no other neighbors, possessions or special treaties, except the Virgin Islands may qualify according to IRS Letter Ruling 9038030}.

7. INVESTMENT OR BUSINESS USE - In a nutshell, both the relinquished and replacement properties must be *held* for investment or business use for a period of time and during this period the properties must not be held for resale or personal use. Internal Revenue Code Section 1031(a)(1).

Basically this (not-so-clear) requirement means the following:

1) You must use the properties as a *rental* property, or for your own *business*-use, or as an *investment* (such as land).{These uses were previously discussed under the like-kind requirement}.

2) You must *not* use the properties for personal use (except for the 14-day\10% exception under the vacation home provisions of IRC 280A. See Section IX).

3) You must *not* hold the properties as *inventory* for *immediate* sale to customers, such as a “dealer” would. An example of those who would be "dealers" in real estate are builders, developers and subdividers who are in the business of selling their property as “inventory” to customers in the normal course of their business. IRC 1221(1).

4) You must not hold the properties "primarily for sale" with the pre-intent to sell [*Ethel Black*, 35 TC 90, l960].

5) According to IRS you must *hold* the properties for a period of at least one to two years.

6) According to IRS, there should be *consistency of ownership* from the relinquished property to the replacement property without any changes for a one or two year period.

THE ABOVE RULES AFFECT THE FOLLOWING CATEGORIES OF *NON*-INVESTMENT (OR NON-BUSINESS) PROPERTY OWNERS:

1) HOMEOWNERS - PRINCIPAL RESIDENCE - A principal residence does not qualify for a 1031 exchange. It does not have to. Principal residences can permanently exclude taxable gains with the $250,000 exclusion for single taxpayers and $500,000 exclusion for married taxpayers filing jointly. IRC 121, effective May 7, 1997. Also, this provision can be combined with 1031 magic. (See Sections VIII-21,22 & 23).

2) HOMEOWNERS - VACATION OR SECOND HOMES - If these are personal-use properties they do not qualify for 1031 tax-free treatment. They can qualify for 1031 treatment if they are converted to rental use. (See Section IX).

3) BUILDERS, DEVELOPERS & SUBDIVIDERS - INVENTORY - Real estate held as “dealer” property (or inventory) for immediate sale is not investment or business use property and will not qualify for a 1031 rollover. However, there is what is known as "dual status" where property owners can be a "dealer" to some property and an "investor" to other property. The mere fact that one is a dealer in property will not disqualify them from 1031 treatment. Moreover, this issue of investor-vs-dealer is a very controversial gray area.
For some planning tips, along with further reference, see the next page.

PLANNING TIPS FOR DEVELOPERS, SUBDIVDERS, ETC. TO AVOID DEALER STATUS AND QUALIFY FOR A 1031 TAX-FREE EXCHANGE:

1. Clearly *separate* the “dealer” property from the “investor” property [See *Walsh* TC Memo 1994-295]. The clearest way to accomplish this is to use <u>separate entities</u> such as a corporation or partnership. (For example, the “dealer” property can be held in a corporation and the “investor” property held individually or in an LLC).
2. Hold the “investor” property for as long as possible. The longer the better. See the next page on holding “time” period.
3. Try to keep down the number of sales to a minimum.
4. Demonstrate and document the “liquidation of investment theory”. Using this argument, property owners (especially “dealers”) argue that they had the requisite *"investment"* intent, but there were factors & circumstances *beyond their control* that forced them to liquidate quickly. The argument maintains the premise that why should the owner be penalized with the “dealer taint” because of factors beyond their control? It can be (and has been) a powerful defense for favorable investor status. For a further discussion of *liquidation of investment*, with case law citations, refer to *The Real Estate Investor’s Goldmine Of Brilliant Tax Strategies* (Section 41 and Appendix E of the Goldmine).
5. Try to do as little as development to the “investor” property as possible.
6. Let an independent real estate agent do all of the selling & marketing. (The less effort you put in, the better your argument for being an investor and not a dealer.)
7. All documents (sales agreements, partnership agreements, tax returns, etc.) should clearly indicate ***“investment intent”.*** <u>Avoid</u> words such as “*development”, “sale”, “sell” “subdivide”*, *“subdivision”*, *“dealer”, “turnover”, “inventory”, “flip”* or any other words denoting *intent to sell.*
8. If the property is rentable (such as a house or apartments) then rent it, or, at least demonstrate that you *attempted to rent* it for at least some period of time* (*discussed on the next page). For this period, you should report it as a *rental property* on the appropriate IRS rental schedules of your tax return (such as Schedule E).
9. You also have to follow these same strategies for the *replacement* property, including holding it for at least some period of time (discussed on the next page).

<u>TAX POINTER 1</u>: Doing the above is no guarantee. However it should reduce risk and strengthen qualification for a 1031 exchange.

<u>OBSERVATION</u>: The above should be done where practical and financially feasible. Keep in mind such activities as frequent sales, development, marketing, etc. are all factors that *may* lead to dealer status. However, they also can lead to substantial profits.

Therefore, don't let the luxury of long term capital gain, and even 1031 exchanges, stop you from making a great deal of money. Moreover, the fact you do these activities will not necessarily make you a dealer. The Internal Revenue Code really does not define a dealer. It is still very controversial*. So keep on exchanging!].

***TAX TIP**: For a multitude of cutting-edge strategies to avoid dealer status, refer to *The Real Estate Investor's Goldmine Of Brilliant Tax Strategies*.

HOLDING REQUIREMENT- HOW LONG MUST YOU HOLD THE PROPERTY?

Although there is this fundamental holding *requirement*, we do not have an objective (safe harbor) time requirement for a holding *period*. We can only look to scant precedent for some guidance. In an IRS letter ruling, the IRS ruled that a 2 year holding period would be sufficient to meet this holding period test [IRS letter ruling 8429039]. However, there are tax court cases where much less time was sufficient (*see the tax pointer below). Conventionally, many 1031 specialists believe there should be *at least* a one to two year holding period. If you hold the property for one year, try to at least overlap into two "tax years". One thing is for sure...

According to IRS, the longer you hold the properties the better and there should be NO prearranged intent to dispose *both* the relinquished and replacement properties during this period. Note that after this holding period, the property can be converted to personal (or any use) tax-free without triggering the taxes on gain.

***TAX POINTER - PROPERTIES QUICKLY SOLD:** These types of exchanges could violate this exchange "holding requirement". However, in certain situations and with advanced planning, these still may qualify. For a further discussion (including cited tax court decisions), see the end of this section, *Quickly Selling Property And The 1031 Exchange Holding Requirement.*

THIS HOLDING REQUIREMENT INCLUDES *CONSISTENCY OF OWNERSHIP* BETWEEN THE RELINQUISHED AND REPLACEMENT PROPERTIES

This *entity-to-entity* concept is further explained as follows:

C-CORPORATION: If the title to the relinquished property is held by a C-corporation, then the title to the replacement property must be held by the same C-corporation. Otherwise, the exchange will not qualify.

S-CORPORATION: Likewise, if the title to the relinquished property is held by an S-corporation, then the title to the replacement property must be held by the same S-corporation. Otherwise, the exchange will not qualify.

NON-GRANTOR TRUST: Likewise, if the title to the relinquished property is held by a non-grantor trust, then the title to the replacement property must be held by the same non-grantor trust. Otherwise, the exchange will not qualify. (Note: If the trust is a grantor or revocable trust, then this may not be a problem, depending on how title is held).

PARTNERSHIP: If the title to the relinquished property has been held by a partnership as an entity, then the *same* partnership entity (with at least 50% of the same partners) should take title to the replacement property in the same manner as the relinquished property. Exception: If the partnership is timely converted to tenants-in-common, then a qualifying exchange is possible for each co-tenant. See next.

CO-TENANTS: If the title to the relinquished property is held by more than one individual as tenants-in-common, then there is more flexibility. Either the same tenants-in-common can take title to the replacement property* or they could go their separate ways as individuals and do their own 1031 exchange .

> *<u>**ALERT**</u>: When more than one individual will take title to the replacement property they must do so as <u>tenants-in-common</u> and *not* as a partnership. *Reason*: A partnership interest does not qualify for a 1031 exchange [IRC 1031(a)(2)(D)], but a tenant-in-common interest does, [Revenue Ruling 73-476]. Therefore, your arrangement will have to be a "Co-Tenancy" and not a partnership. Each Co-tenant is to report their respective share of rents and expenses on the applicable schedule of their individual tax returns (usually page 1 of IRS Schedule E). Do <u>NOT</u> file a partnership tax return (IRS Form 1065 & K-1).

INDIVIDUAL: If the title to the relinquished property is held by one individual, then there is flexibility. Either the same individual can take title to the replacement property* as an individual or they can do so with other individuals as tenants-in-common*.

> *<u>**REMINDER ALERT**</u>: When more than one individual will take title they must do so as <u>tenants-in-common</u> and *not* as a partnership. *Reason*: A partnership interest does *not* qualify for a 1031 exchange, but a tenant-in-common interest does.

> <u>**ALERT ON MINIMUM REINVESTMENT AMOUNT IN REPLACEMENT PROPERTY**</u>**: If you do acquire the replacement property with others, then to totally defer the tax on the gain, then your part co-tenancy interest in replacement property must equal or exceed your respective percentage of the *net selling price* of your relinquished property**-. *Net selling price* is the total sales price less commissions, transfer taxes and other selling expenses. Accordingly, your part percentage interest in the identified replacement property must equal or exceed your respective percentage of this *net selling price*. Otherwise you will have at least a partial taxable gain (called "boot"). {For a further discussion of this minimum reinvestment amount (net selling price), see Section V.}

JOINT OWNERSHIP - SPOUSES: If the relinquished property were held in one spouse's name and the replacement property will be held jointly or vice versa, then a joint tax return should be filed for at least one to two years (joint returns are generally filed anyway as they are usually more beneficial).

CHANGES OF OWNERSHIP -- IRS VIEWPOINT: The IRS has ruled that changes of ownership that are proximate to an exchange violate this holding requirement and therefore cause the exchange to be disqualified. [IRS Revenue Rulings 75-292 & 77-337].

CHANGES OF OWNERSHIP -- TAX COURT: However there are several tax court cases that disagree [*Bolker*, 81 TC 782 (1983); *Mageneson*, 81 TC 767 (1983)]. Moreover, IRC 1031 (a) does allow partners to elect out of partnerships and become tenants-in-common.

Ideally, this consistency of ownership from the relinquished property to the replacement property should be maintained without any changes for at least one year. Again, if you do not maintain it you still have a defensible position based on the above. However, you may increase your risk with the IRS.

<u>REMINDER</u>: A partnership interest does *not* qualify for 1031 while a tenant-in-common does.

<u>TIP</u>: Transfer of the replacement property to a single-member LLC does not violate this holding requirement and will thus qualify, IRS Private Letter Ruling 9807013.

FOUR MORE OBSERVATIONS ABOUT THIS REQUIREMENT

(1) IT PERTAINS TO *BOTH* THE RELINQUISHED PROPERTY AND THE REPLACEMENT PROPERTY (The same is true for the like-kind requirement).

(2) IT PERTAINS *ONLY* TO THE EXCHANGOR\INVESTOR SEEKING THE BENEFITS OF 1031. What the other parties do with the properties is of no relevance to the investor. (The same is true for the like-kind requirement).

> <u>EXAMPLE</u>: As we have learned, personal-use property does not qualify for 1031. Suppose you have owned a single family *rental* for a number of years. The property is being leased to a tenant with a lease-option to buy. If you sell to the tenant, you can qualify for 1031 treatment, even though the home was used personally. This is because the "personal-use" was on the part of the *other* party (the tenant-buyer) <u>not</u> you. *Your* "qualifying use" was rental (and qualified 1031 treatment).

(3) DON'T CONFUSE *"BUSINESS-USE"* PROPERTY WITH *"DEALER"* PROPERTY"

"Business-use" property is property you would own and use in your own business, such as an office building for your own real estate company or a plant for your manufacturing operation. This use has to do with the *operations* of the property, not selling. You will *hold* this property and *not* sell it (at least for a while).

On the other hand *"dealer"* property is property that is held as " inventory" for immediate sale to customers. IRC 1221(1). It's like "widgets" on a shelf waiting to be sold. This use has to do with *selling,* not operations. You will *sell* and *turnover* this property as quickly as possible and *not* hold on to it.

(4) THIS REQUIREMENT IS THE GRAYEST ONE and requires *advanced* 1031 tax reduction planning with a competent *1031 exchange specialist.*

<u>NOTE</u>: ALL of the above requirements must be satisfied. They can be complex. Therefore, a 1031 *Exchange Tax Specialist* is highly recommended. Call 1-800-351-1031.

Quickly Selling Property And The 1031 Exchange Holding Requirement

In real estate jargon, selling quickly (or "flipping") is broken down into 2 major categories: (1) *Wholesaling* and (2) *Retailing*. (1) *Wholesaling* - This is selling the property "as is" with little or very little fix-up. Many times the entrepreneur never goes to settlement. They just assign (or "flip") the agreement of sale. (2) *Retailing* (or *Reahbbing*) - This is selling the property after doing at least a fair amount of fixing up. Often the fixing up is substantial. Most of the time the entrepreneur goes to settlement to buy the property, does the rehabbing and then sells the property all fixed up.

HOLDING REQUIREMENT: 1031 exchanges have a number of IRS requirements. One of these requirements is that both the relinquished and replacement property must be *held* for investment or business use. Internal Revenue Code Section 1031(a)(1). (emphasis added). This requirement is known as the "holding requirement", as discussed in this section.

IRS INTERPRETATION: The IRS interprets this "holding requirement" to mean that both the relinquished and replacement property must be held for a certain "time" period.

HOLDING REQUIREMENT IN RELATION TO QUICK FLIPS: Accordingly, conventional thinking is that a quick flip of a property will not qualify for the tax deferral benefits of a 1031 exchange, because of this exchange holding requirement.

NO SPECIFIC TIME PERIOD: But the tax law does not give us a specific, objective holding (time) period requirement for both the relinquished and replacement property.

IRS VIEWPOINT ON TIME PERIOD: In a private IRS letter ruling, the IRS ruled that a two year holding period would be sufficient to meet this holding period test [IRS Letter Ruling 8429039]. In 1989, there was an IRS proposal (never enacted) for one year.

TAX COURTS' MORE LIBERAL VIEWPOINT ON TIME PERIOD: However, IRS letter rulings, and certainly proposals, do not have the force or effect of law. Accordingly, the tax courts have been much more lenient in ascertaining that a property has been held long enough to qualify for Section 1031 tax-free treatment. In one tax court case nine months was sufficient [*Wagenson* 74 TC 683 1980]. In another case <u>six months</u> was enough [*124 Front St. Inc.* 65 TC 6 (1975), 1976-2CB 3]. In *Allegheny County Auto Mart, Inc.*, the property was held <u>five days</u> before the sale\exchange [TC Memo (1953)]. In *Rutherford*, the transfer was <u>immediate</u> [TC Memo 1978-505]. (Underlined emphasis added),

See also *Bolker*, 81 TC 782 (1983) and *Mageneson*, 81 TC 767 (1983). *Bolker* and *Mageneson* involved the immediate changes of ownership. According to the courts, such immediate changes did not violate the exchange holding requirement. However, the IRS's position is that they do violate the exchange [IRS Rev. Rulings 75-292 & 77-337].

TIME PERIOD -- IRS VS. TAX COURTS: Based on the above, the IRS's position would appear to be a holding (time) period of one to two years, while the tax court's position is immediate to nine months.

THE CONCLUSION WITH FLIPS: Quick flips will probably not qualify within the IRS, but may qualify in the eyes of the tax court. Accordingly, doing a 1031 exchange for a quick sale is generally going to be riskier with the IRS, with wholesaling (as opposed to retailing) being the riskiest of all, especially the assignment of contracts (see below*). However, **it will not be illegal because there is no safe-harbor time period, plus you have a defensible position with the above tax court decisions**.

**Contracts*: It is unclear if a contract or option (itself) can qualify as like-kind property in a 1031 exchange. To qualify it would have to be considered an interest in real property. The courts have considered contract rights to purchase real property as real property rights. See *Starker v. US*, 602 F2d 1341 (CA9, 1979). At least some 1031 experts believe than treating a contract or option as like-kind to a fee interest in real estate is highly questionable.

Sometimes a contact to purchase real estate extends for a lengthy period of time. Thus, if the contract or option was held for one to two years, then it may have a better chance to qualify. One thing is for sure -- none of us are sure!

Rehabbng: Because of the longer holding period, rehabbing would have a better chance to qualify for a 1031 exchange than wholesaling.

> **<u>1031 TAX TIP 1</u>**: With rehabbing consider extending the holding period with a short to mid-term lease-option. This would help to ensure favorable 1031 tax-free recognition. Here, you help avoid dealer status on the flips by demonstrating that you have also have "rental\investment" intent with your property, as per the Supreme Court case *William Malat*. See *The Real Estate Investor's Goldmine Of Brilliant Tax Strategies*, (Section 41 and Appendix E).

> **<u>1031 TAX TIP 2</u>**: Engage a Qualified Intermediary (QI) that specializes in complex exchanges, such as those combined with flips. One such QI is CPA Exchange Services, Inc. (*CESI*) who has done exchanges in over 40 different states. Call 1-800-351-1031.

<u>OVERALL 1031 PLANNING TIP</u>: For those who want to use 1031 exchanges for flips, follow the planning strategies to avoid the "dealer taint". You especially want to adhere to the strategy for minimizing dealer status by reducing your chances of an IRS audit. *Reason*: NO audit = NO controversy = NO problem! For a further discussion of the above, refer to *The Real Estate Investor's Goldmine Of Tax Strategies* (new updated second edition) by Albert Aiello. To order, see REINFO.com.

V. 1031 EXCHANGE COMPUTATIONS *PLUS* PLANNING TIPS - THERE'S *MAGIC* IN NUMBERS

The favorable wealth accumulation benefits of 1031 require *advanced* planning and prudent decision making which can only be effectively made through the use of *accurate* computations. Therefore you need to have a least a general understanding of 1031 exchange computations and the rollover process.

THE BASIC COMPUTATION-STEPS IN THE *1031 ROLLOVER PROCESS*:

STEP 1: Compute the *NET* SELLING PRICE of the relinquished property. (This is the total selling price less selling expenses. It is also the minimum amount necessary that must be reinvested in replacement property to totally avoid taxes.)

STEP 2: Compute the ADJUSTED TAX BASIS of the relinquished property. (This is the original cost, plus improvements, less depreciation and prior deferred gains.)

STEP 3: Compute the total REALIZED GAIN of the relinquished property. (This is the difference between steps 1 and 2 above. This is the total amount of gain that can ever be reported as taxable gain in a sales transaction.)

STEP 4: Compute the TAXES on the above REALIZED GAIN. (You arrive at this by multiplying the investor's *total* tax bracket times step 3 above.)

STEP 5: Compute the BOOT (TAXABLE) GAIN, if any. (This will depend on the amount of the reinvestment into the replacement property. See pages 44 to 47.)

STEP 6: Compute the DEFERRED GAIN. (This is the gain *not* taxed in the 1031 rollover.)

STEP 7: Compute the BASIS of the new replacement property acquired via 1031. (This is the total cost of the replacement property less the above deferred gain.)

EXAMPLE 1: The selling price of your relinquished property is $80,000, commissions are $5,000 and other selling expenses are $1,000. You originally paid $38,000 and incurred another $2,000 in (basis) closing costs for a total cost of $40,000. You did capital improvements of 10,000; deducted a total of $21,000 depreciation and there was a prior deferred gain of $5,000 on a prior 1031 rollover. Assume a total tax bracket (or rate) of 30%. With this information, you can quickly complete steps 1 to 4:

STEP 1: Compute the *NET* SELLING PRICE (or "amount realized") of the relinquished property. This is the total selling price less selling expenses as follows:

1. > TOTAL SELLING PRICE......................	$80,000
2. Less: COMMISSIONS.............................	- 5,000
3. Less: Other costs of sale	- 1,000

4. Equals: NET SELLING PRICE **= $ 74,000** (amount realized)

STEP 2: Compute the ADJUSTED TAX BASIS of the relinquished property.

5. > Org. Cost (including closing costs)	$40,000
6. Plus: Capital Improvements	+10,000
7. Less: All Prior Depreciation	- 21,000
8. Less: A Prior Deferred Gain	- 5,000

9. Equals: ADJUSTED TAX BASIS **= $ 24,000**

STEP 3: Compute the total REALIZED GAIN of the relinquished property. This is the difference between steps 1 and 2 above. The difference between the net selling price of $74,000 (line 4) and the adjusted tax basis of $24,000 (line 9) leaves a taxable realized gain of $50,000 (without Section 1031).

NET SELLING PRICE	**$ 74,000**
Less: ADJUSTED TAX BASIS	**- 24,000**

10. Equals: REALIZED GAIN **=$ 50,000**

STEP 4: Compute the TAXES on the above REALIZED GAIN by multiplying the investor's *total* tax bracket times the above gain. When you multiply the gain of $50,000 times the assumed total tax rate of 30% you arrive at the amount of **taxes due of $15,000** (without Section 1031).

NOTE: For a further explanation of the line items in the above computations, see pages 50 to 52 at the end of this section.

<u>STEP 5</u>: Compute the <u>BOOT (TAXABLE) GAIN</u>, if any. Whether there will be any taxable boot in a 1031 rollover will depend on how much is invested in replacement property. In a move-*down* exchange, you will always have taxable boot. In a move-*up* exchange, you will have taxable boot if you take out cash during the exchange. (Move-down exchanges, move-up exchanges and "boot" are discussed later in this section.) To have an exchange without any taxable boot (that is a *total* tax free exchange), you must do two things:

(1) Use all of the net cash equity from the old property as a down payment on the new replacement property.

(2) Acquire like-kind replacement property whose cost <u>equals or exceeds</u> the *Net Selling Price* of your relinquished property (see Example 2 below).

<u>EXAMPLE 2</u>: Referring to the previous Example 1, the net selling price of the relinquished property was $74,000. Assume the mortgage owed on the property is $14,000 (leaving a net equity of $60,000). **The net selling price of $74,000 is the minimum cost amount that you must reinvest in replacement property, to totally avoid taxes on the exchange.** It is your *Minimum Reinvestment Amount.*

- It is <u>not</u> the net equity of $60,000 (you do <u>not</u> subtract the mortgage of $14,000*).
- It is also <u>not</u> the realized gain of $50,000 (computed on page 42)
- It is also <u>not</u> the *total* selling price of $80,000 (computed on page 42)

Again, it *is* the NET SELLING PRICE OF $74,000. That is, to *totally* defer the taxes on your gain, you must acquire replacement property for a cost of $74,000 *or higher.*

> [*NOTE: In this Example, to equal or surpass the $74,000 threshold, you will have to get a mortgage on replacement property for at least the $14,000 old mortgage. Alternatively, you can use your own cash to make up the difference]
>
> **<u>1031 TAX TIP</u>***:* You are not limited to just one replacement property in arriving at the $74,000. You can acquire up to 3 properties and in some cases even more. For example, if you acquire 3 replacement properties at $25,000 each or a total of $75,000, you have more than made the minimum reinvestment of $74,000. Besides *diversifying* your investment portfolio, you have *totally* avoided paying taxes.
>
> **<u>RECOMMENDATION</u>:** Do not throw all of your eggs in one basket! You should *diversify* into more than one replacement property and exchange *up* into *more valuable* real estate which could give you more cash flow, more equity and higher yield.

A PARTIALLY TAX FREE-EXCHANGE ("BOOT")

"BOOT" is any taxable income in a 1031 exchange. IRS regulations* do permit in one transaction a part 1031 tax-free rollover and a part taxable sale (similar to a "move-down" buyer in a 1034 rollover). You do not have to reinvest all of the equity in your relinquished property into another like-kind property. The difference can be received as partial taxable boot, such as cash (or other non-like property). [*Regulations 1.1031(b)-1; 1.1031(k)-1(f) and 1.1031(k)-1(h)(3)].

TAXABLE BOOT: Taxable boot will *always* be incurred in a move-down exchange, <u>even if you do not take out any cash</u> (see below). Boot can also be incurred in a move-up exchange, if you take out cash *during* the exchange (discussed later in this section).

MOVE-*DOWN* 1031 ROLLOVER

If you invest in a *lower*-priced replacement property, the *down* difference between the net selling price of the relinquished property and the cost of the replacement property is taxable income ("boot"). However, the amount of this taxable boot cannot exceed the total realized gain.

<u>EXAMPLE 3</u>: As per the last example, the net selling price of the relinquished property is $74,000. The realized gain is $50,000 (computed on page 42). Assume that the cost of the replacement property is $54,000. The result is $20,000 of taxable (boot) income which is the difference between the net selling price of the relinquished property ($74,000) and the lower cost of the replacement property ($54,000). The $20,000 is lower than the total realized gain of $50,000 and is therefore the *taxable* amount of boot gain.

<u>ALERT</u>: **IN A MOVE-DOWN EXCHANGE:** There is a common and often costly misconception that in a move-down 1031 rollover if you do not take out any boot cash in the first closing of the relinquished property, but instead use it as a down payment on the replacement property, there will be no boot income at all. <u>This is not true</u> because you are still not using all of your equity to acquire the lesser priced replacement property. Here you will be obtaining a smaller mortgage on the replacement property because of the larger down payment. By obtaining a mortgage on the replacement property that is smaller than the relinquished property, you are relieving yourself of debt. "*Relief of Debt"* is also another form of boot income. Thus instead of being taxed as *cash* boot income, the $20,000 would now be taxed as *liability (or debt)* boot income. The big difference is that the first type is at least *cash* (taxable) income, but the second type (debt relief) is *non*-cash (*"phantom"*) taxable income.

<u>FOR PLANNING TIPS TO AVOID BOOT IN A MOVE-DOWN 1031</u> - See the following two pages >>>

<u>TAX PLANNING TIP 1</u>: TAKE THE TAXABLE BOOT AS <u>CASH</u>

Because you are going to be taxed on the $20,000 anyway, then you should take it out as cash either at the settlement of the relinquished property or after the final completion of the 1031 exchange.

> [<u>CAUTION</u>: Once the money is in the 1031 exchange escrow account, then *no* cash should go to you. In other words any cash takeouts are to be taken out <u>before</u> or <u>after</u> the 1031 exchange escrow period, *not* during].

Taking out the boot cash has several important advantages:

- ∗ You have the <u>cash in hand</u> instead of being locked into the replacement property
- ∗ By not using it as a down payment on the replacement property, you are using more *leverage*, which has the potential to <u>increase your yield</u>
- ∗ You have <u>more time to invest</u> the moneys and earn income
- ∗ You will have the <u>cash to pay the taxes</u> on the boot income and even <u>avoid costly penalties</u> by making timely quarterly estimated payments.

ALTERNATIVELY YOU MAY NOT WANT TO TAKE OUT THE BOOT AS CASH

This may be especially appropriate where you have other losses or deductions to offset the taxable boot. Moreover, you may want to (or need to) put the boot cash as an additional down payment. This could be for several reasons:

- More investor comfort with little or no debt
- The lender requires more of a down payment
- It's the only way to get seller financing
- It's the only way to get a bargain (*cash = discounts*)
- It's the only to make the “deal” fly!

Plus, you could always refinance at a later date. (See the next section)

ALTERNATIVELY YOU MAY WANT TO TAKE OUT *SOME* OF THE BOOT CASH

Whatever you do and whatever the reasons, it is imperative that you be *fully* informed of <u>all</u> ramifications, both tax and non-tax. You can then make an *intelligent* decision.

PLANNING TIP 2: INVEST IN *MORE* REPLACEMENT PROPERTY

You can avoid the boot income by acquiring more replacement property. Remember you are not limited to just one replacement property in arriving at the $74,000. You can acquire up to 3 properties and in some cases even more (see Section IV). For example, if you acquired more replacement property for at least $20,000, you eliminate the taxable boot and save yourself $6000 in taxes (assuming a 30% tax bracket). If the new property costs $20,000 it's as if you received a discounted price of $14,000 ($20,000 less the $6000 tax savings). Again, you should *diversify* into more than one replacement property and you should exchange *up* into *more valuable* real estate which could give you greater cash flow, more equity and higher yield.

PLANNING TIP 3: ADDITIONAL CAPITAL IMPROVEMENTS VIA AN "IMPROVEMENT EXCHANGE" CAN REDUCE OR ELIMINATE ANY BOOT TAXABLE GAIN IN A MOVE-DOWN EXCHANGE

In this Example of an exchange-down transaction suppose you further determine that the replacement property will need real property improvements of at least $20,000 (in addition to the purchase price of $54,000). The sum of these amounts equates to the minimum reinvestment amount of $74,000. To accomplish this you must follow the rules of a "construction or improvement exchange." (See Section VIII-11.)

PLANNING TIP 4: INSTEAD OF AN "IMPROVEMENT EXCHANGE", HAVE THE OWNER OF THE REPLACEMENT PROPERTY FIRST DO THE NECESSARY IMPROVEMENTS BEFORE ANY PROPERTY TRANSFERS. THIS TOO CAN REDUCE OR ELIMINATE ANY BOOT TAXABLE GAIN IN A MOVE-DOWN EXCHANGE

If feasible, an easier alternative is to have the owner of the replacement property do the necessary real property improvements *before* any transfer of properties has occurred. You then complete the exchange within the required time limitations. Suppose the owner does $20,000 of improvements to the $54,000 property. Now the replacement property can be acquired at the higher purchase price of $74,000 which is the *net selling price* of the relinquished property (and the minimum amount necessary to totally eliminate the boot income of $20,000).

PLANNING TIP 5: COMBINE THE MOVE-DOWN 1031 EXCHANGE WITH A PRIVATE ANNUITY TRUST (PAT)

Another way to avoid boot taxable income in a move-down exchange is to use a *private annuity trust* (*PAT*) for the part of the net sales proceeds not invested in like-kind real estate. With the PAT, these proceeds can be invested in non-real estate assets such as stocks, bonds, mutual funds, a business etc. For a further discussion, see Section VIII-25.

MOVE-*UP* 1031 ROLLOVER WITH TAXABLE BOOT

Taxable boot will occur in a move-up 1031 rollover, when you invest in a *higher*-priced replacement property, do not use up all of the equity in your old property, obtain a higher (than needed) mortgage on the new property and **take out the difference as cash**. Because it is taken out *during* the exchange, this cash takeout (up to the total realized gain) is also taxable ("boot") income.

EXAMPLE 4: Referring to the prior example, the net selling price of your relinquished property is $ 74,000. The mortgage balance on the property is $14,000, leaving $60,000 net equity in the relinquished property. This $60,000 will be available for down monies on the replacement property. Assume that you will be moving up to a higher priced replacement property for a total cost of $120,000 (including closing costs) and a mortgage of $90,000. This would require a down payment of $30,000 ($120,000 less $90,000). Because you only have to put down $30,000 (instead of $60,000) you cash out on the difference of $30,000. This cash-out difference is taxable boot, summarized below:

A. MOVE-*UP* 1031 WITH TAXABLE CASH TAKEOUT *DURING* THE 1031

DATA ON RELINQUISHED PROPERTY BEING SOLD VIA 1031:

1. NET SELLING PRICE ....$ 74,000
2. Less: Mortgage Payoffs................... - 14,000
3. Equals: NET EQUITY......... =$ 60,000

THE INVESTOR IS EXCHANGING UP (IN PRICE) TO A REPLACEMENT PROPERTY:

4. Cost of Replacement Property............ $ 120,000
5. Less: New Mortgage Obtained............ - 90,000
6. Equals: DOWN PAYMENT\EQUITY =$ 30,000

THE *DOWN-DIFFERENCE* IN EQUITIES RESULTS IN BOOT AS FOLLOWS:

7.> EQUITY - Relinquished Property $ 60,000 (line 3)
8. Less: EQUITY - Replacement Property - 30,000 (line 6)
9. Equals: "BOOT" GAIN............. = 30,000* (taxable income)**

{*Note: The taxable boot can never be higher than the realized gain (which in this EG is $50,000)

*****TIP ON HOW TO AVOID TAXABLE BOOT*:** If you refinance <u>before or after</u> the exchange, then cash takeouts in a move-*up* 1031 rollover can be tax-free.{see the next section, *HOW TO TAKE OUT <u>TAX-FREE</u> CASH FROM A <u>TAX-FREE</u> 1031 EXCHANGE}*

<u>STEP 6</u>: COMPUTE THE <u>DEFERRED GAIN</u>. THIS IS THE UNTAXED GAIN ON THE 1031 ROLLOVER. THE DEFERRED GAIN IS THE DIFFERENCE BETWEEN THE REALIZED GAIN AND THE BOOT TAXABLE GAIN.

<u>EXAMPLE 5</u>: Referring to our original Example 1, there was a $50,000 realized gain. In Example 4 (which stems from Example 1), there was a move-up rollover that has the same $50,000 realized gain but which resulted in boot taxable income of $30,000. The deferred (or untaxed) gain of $20,000 is the difference between $50,000 and $30,000 **--** $20,000.

> [<u>NOTE</u>: It is this deferral that creates the *"1031 Window of Opportunity".* Deferred gain is the gain not currently taxed and this is what 1031 rollovers are all about - postponing taxes so that they could be reinvested into other opportunities. The ideal situation is to defer all gain or as much gain as possible, and for the longest possible time. The more gain deferred, the greater amount of tax savings which could be available for investment. The longer the period of deferral, the more time that the investor will have to invest these tax savings into other investment opportunities, such as real estate. All of this is based on the wealth accumulation concept known as the "Time Value of Money" - MORE is better than less and SOONER is better than later. 1031 magic gives you the best of both -- MORE and SOONER. And if you defer until death, then the taxes become *permanently eliminated*].

<u>STEP 7</u>: COMPUTE THE <u>BASIS</u> OF THE NEW REPLACEMENT PROPERTY ACQUIRED VIA 1031. THIS IS THE TOTAL COST OF THE REPLACEMENT PROPERTY LESS THE ABOVE DEFERRED GAIN.

<u>EXAMPLE 6 -- MOVE-*UP* ROLLOVER</u>: In Example 4, there was a move-up rollover to a higher cost replacement property of $120,000. The deferred gain computed in Example 5 above was $20,000. Therefore the basis of the replacement property is $100,000 which is the cost of $120,000 less the deferred gain of $20,000.

ALTERNATE BASIS COMPUTATION: Another way to compute the basis of the replacement property is to add to the old basis, the increase in prices (if any) from the relinquished property to the replacement property. Based on this, there are these two rules:

(1) IN A MOVE-*DOWN* ROLLOVER, the basis of the replacement property will be the *same* as the old basis in the relinquished property.

<u>EXAMPLE 7 -- MOVE-*DOWN* ROLLOVER</u>: In Example 3, there was a move-down rollover to a lesser priced property of $54,000. The boot taxable gain was $20,000, the realized gain $50,000 and the deferred gain would be the difference of $30,000. The basis of the relinquished property was $24,000. Because there is no increase in value by moving down, the $24,000 is also the basis of the replacement property proven as follows.

Cost of replacement property $54,000
Less: Deferred gain - 30,000
= Basis replacement property $24,000

(2) IN A MOVE-*UP* ROLLOVER, the basis of the replacement property will increase. It's the old basis, *plus* the difference between the increment in prices from the relinquished to the replacement property, *plus* any taxable boot.

EXAMPLE 8 -- MOVE-*UP* ROLLOVER: In Example 4, there was a move-up rollover from a net selling price of $74,000 to a higher cost replacement property of $120,000 (includes basis closing costs). This increase from $74,000 to $120,000 is $46,000. The boot taxable income was $30,000. The old basis was $24,000. Using this alternate computation, the new basis of $100,000 is computed as follows:

Old basis - relinquished prop $24,000
Add: Increase in prices............. 46,000 ($120,000 less $74,000)
Add: Taxable boot.................... 30,000
= Basis replacement property $100,000

NOTES TO STEP 7 ABOVE:

(A) The above basis computations do include closing costs. This is done in the computation of the increase in prices by using the *total cost* of the replacement property, which includes the purchase price *plus* basis closing costs. On the other side of the computation is the *net* selling price of the relinquished property (after deducting *selling expenses*) instead of using the total selling price. The result of using the *higher* cost amount on the replacement property and the *lower* net selling price on the relinquished property is a higher increase in prices and a higher basis.

(B) The new cost basis will be used for computing depreciation deductions as well as gain or loss, if the property were to be sold outright, or otherwise disposed of.
It's as if the property were purchased for this basis amount. When a gain is not currently taxed because of a 1031 rollover, the untaxed capital gain does not go away but stays with each rollover (until death). It would become taxable if the property were eventually sold outright. Reducing the purchase cost of the replacement property by the deferred gain (or by using the above alternate computation) to arrive at its basis, maintains this deferral requirement.

THE REMAINDER OF THIS SECTION IS A FURTHER EXPLANATION OF THE LINE ITEMS IN THE COMPUTATIONS ON PAGE 42 --

LINE 1 - SELLING PRICE -- The selling price (or the amount realized from the sale) includes cash received, the fair market value of any property received (such as a boat, car, note, etc.) and any mortgages or liens assumed by the buyer, IRC 1001(b); Reg. 1.1001-2(a).

LINE 3 - OTHER COSTS OF SALES -- These expenses (along with Realtor commissions) reduce your taxable gain. Examples are transfer taxes, advertising, 1031 intermediary fees, legal fees, deed preparation, termite certifications and recording fees. Selling expenses would even include seller assists and items that are obligations of the buyer (or that are customarily paid by the buyer) such as points, buydowns, transfer tax, title insurance, environmental studies, survey, etc. Included in this category would be any credits given by a seller in favor of a buyer, sometimes known as "seller assists" or "seller concessions".

LINE 5 - *ORIGINAL COST* (INCLUDING CLOSING COSTS) -- This is the original contract price paid for the property (from the original closing statement or HUD 1 settlement sheet) plus basis closing costs*, most of which would generally appear on the HUD 1 sheet.

> **Basis closing costs* -- Included as part of line 5 are closing costs to acquire or defend title to property such as title insurance, title fees, transfer tax, legal fees, recording fees, survey, etc. Such costs are part of the cost basis of the relinquished property (as well as the replacement property). <u>Note</u>: Closing costs which are <u>no</u>t included as part of basis are points, real estate taxes, interest, PMI or MIP premiums, hazard insurance. These types of closing costs are <u>not</u> added to the property basis, but instead have their own respective tax treatment, beyond the scope of this book].

LINE 6 - CAPITAL IMPROVEMENTS -- "Capital Improvements" are essentially those expenditures that will add value to the property or prolong its life. Capital improvements are added to the basis of the property and cannot be written off in the first year but are depreciated over a period of time by way of what are called statutory "recovery periods." (See Section VIII-3.) On the other hand, "repairs" just maintain the property in operating condition and are not added to basis, but are deductible as a property operating expense (and therefore are not part of these computations). The distinction between capital improvements and repairs is not always clear-cut. However, the aforementioned is a general guideline and sufficient enough for our purposes here.

LINE 7 - ALL PRIOR DEPRECIATION TAKEN -- When the owner wants to dispose of their investment property, *all* depreciation allowed *(or that should have been allowed)****** must reduce the basis of the property. This basis reduction has the same effect of adding back the depreciation to the realized taxable gain. This line item is simply a summation of the previous annual depreciation deductions taken by the property owner. (For more information on depreciation see Section VIII-3 or refer to free IRS Publication 534.)

***ALERT**: It’s depreciation allowed or *allowable*. Even if depreciation deductions were not taken by the property owner, they still must be added back to the taxable gain.

TAX TIP: Take depreciation deductions every year. However, if you missed taking depreciation, then get it back all one year without having to file amended returns. Instead you can claim the understated deductions (including closed tax years) as a current year deduction. Do this by filing IRS Form 3115 - *Application for Change in Accounting Method*. For a further discussion, see *The Real Estate Investor’s Goldmine Of Brilliant Tax Strategies*.

LINE 8 - PRIOR DEFERRED GAIN -- When a gain is not currently taxed because of a deferred rollover, the untaxed gain stays with each rollover and would become taxable if the property were eventually sold in a taxable disposition. This is why the untaxed gain is called a "deferred gain". Any gain that is deferred because of a non-taxable rollover (such as a 1031 exchange) reduces the cost basis of the replacement property. This in turn increases the realized gain. The property being sold may have been a replacement property that deferred all or part of a gain in a prior 1031 exchange or another tax-deferred rollover such as:

(a) Rollover of Gain Pertaining To The Sale of a Principal Residence (former IRC 1034). This law only applied to principal residences and not to investment properties. But it is still possible that this property was once the owner's home and was later converted into its present status as a rental property. If the original home was a replacement residence that deferred any gain on a prior sale, then this deferred gain reduces the cost basis of this property and thus increases the realized gain. (If this were the case, then this property would typically be a single family home or owner-occupied duplex dwelling.)

[Note: On May 7, 1997, IRC 1034 was repealed. However, any Section 1034 deferred gains still continue to reduce a property’s basis and increase gain as per the above]

(b) *Involuntary Conversion* Due to a Casualty (Fire, Flood, etc.), or Government Condemnation (IRC 1033). Here, gain is realized from the insurance reimbursement for property destruction (such as fire, flood, etc.), or compensation from government condemnation. IRC 1033 applies to both personal-use and investment property and can defer taxes on gain if certain tests are met, including acquiring replacement property. If the property being sold was the replacement property that deferred any gain on a 1033 conversion, then the deferred gain reduces the cost basis of this property and increases the realized gain. (For a further discussion of involuntary conversion, see IRS Pub. 544)

ALERT: Other items that reduce basis (and increase gain) are partial sales, deductible casualty losses (IRC 165) and cancellation of debt (IRC 108).

TAX TIP: These basis adjustments should be ascertained from the owner's tax advisor.

[NOTE: BASIS *OTHER* THAN PURCHASE: The example here assumes the property was originally *purchased* by the owner. However if the property was received by way of inheritance or gift, other special basis rules apply. For inherited property, the original basis would be the fair market value of the property as determined by the estate (which is usually the date of death). For gifted property, the original basis would be the original donor's basis which is generally lower than the fair market value. There can be other basis issues if the property was acquired by divorce. The above is a very quick overview of these rules. If they apply, you should consult with competent tax counsel]

LINE 10 - REALIZED GAIN -- This is also referred to as the "Capital Gain" or "Realized Taxable Gain" (or even "Taxable Gain"). I no longer say "capital gain" because not all of the gain on the sale of real estate may be eligible for lower federal capital gain taxes. Part (or even all) of a gain may be *ordinary income* from using an *accelerated* method of depreciation. Any such amount of ordinary income is subject to rates as high as *39.6%.* Moreover, the gain can also be subject to state and local taxes. There could also be additional income taxes from an increase in AGI which in turn reduces certain tax benefits. Therefore the realized taxable gain could be subject to *multiple* tax liabilities. A 1031 exchange can legally avoid ALL of these taxes.

REMINDER: The amount of the realized gain is the limit on any boot taxable income.

TAX POINTER: Certain "loss carryovers" can reduce realized gain and any resultant tax liabilities. Check with your tax advisor]

TAX ALERT: **The mortgage payoff* does *not* reduce taxable gain**.

***TAX TIP**: **Check to see of the mortgage payoff includes deductible items such as interest, prepayment penalty or other costs**. Sometimes lenders include these types of items in the principal loan payoff. They should be separated and deducted accordingly.

TOTAL TAX RATE -- Because there are multiple tax liabilities on the sale of a property, the owner's *total* rate on the gain should include:

FEDERAL TAX RATES: Effective May 6, 2003 there is a maximum federal long-term capital gain rate of 15%. There was a 20% federal long-term capital gain rate which was temporarily eliminated on May 5, 2003 and is scheduled to be reinstated January 1, 2009. But the tax rate on straightline depreciation is 25%. There can be higher federal tax rates because of ordinary income from accelerated depreciation and an increase in AGI, as discussed above. Also, see Section II.

STATE & LOCAL TAX RATES: Most states (and even some locales) also tax gains, but they also generally allow the use of 1031 *Tax-Free* exchanges. A state and/or local tax can be as high as 9%.

For purposes of simplicity, most examples in this publication assume all gains to be taxed at a *total* tax bracket of a rounded 30%. For a further discussion of the above, refer to Section II.

VI. 1031 *CASH MAGIC*

HOW TO TAKE OUT <u>TAX-FREE</u> CASH FROM A <u>TAX-FREE</u> 1031 EXCHANGE

As discussed in the last section, taxable boot can occur in a move-up 1031 rollover. It happens when you invest in a *higher*-priced replacement property, do not use up all of your equity in the old property, you obtain a higher (than needed) mortgage on the new property and take out the difference as cash. Because it is taken out *during* the exchange, this cash takeout (up to the total gain) is also taxable ("BOOT") income

A better way to extract cash out of a move-*up* exchange is to refinance <u>before</u> or <u>after</u> the exchange. If properly structured, this cash takeout can be totally tax-free.

> EXAMPLE - In example 4 of the last section, the net selling price of the relinquished property was $74,000. The mortgage balance - $14,000, leaving $60,000 net equity in the relinquished property. This $60,000 will be available for down monies on the replacement property. You are moving up to a higher priced replacement property for a total cost of $120,000 (including closing costs) and a mortgage of $90,000. This would require a down payment of $30,000 ($120,000 less $90,000). Because you only have to put down $30,000 (instead of $60,000) you cash out on the difference of $30,000 which is taxable boot.

The way to avoid this $30,000 from being taxable is to refinance the *relinquished* property *before* you exchange and take out the $30,000 then (via the refi).Alternatively you can refinance the *replacement* property *after* the exchange and take out the $30,000 then. By doing it *before* or *after* (not during) the exchange, the cashout refi is tax-free. Both of these tax-free scenarios are summarized as follows:

1. **REFINANCE TAX-FREE *BEFORE* THE EXCHANGE**

In this scenario, if you refinance the relinquished property mortgage from $14,000 to $44,000 the net equity of the relinquished property will then be $30,000 which is equal to the net equity of the replacement property. The result is no boot taxable income. In the meantime, when you refinance prior to the exchange, you can pull out the $30,000 difference as tax-free refi proceeds. This is summarized on the next page.

<u>NO</u> BOOT: MOVE-*UP* 1031 EXCHANGE - REFINANCE *RELINQUISHED* PROPERTY WITH CASH TAKEOUT <u>BEFORE</u> THE 1031 ROLLOVER

DATA ON <u>RELINQUISHED</u> PROPERTY BEING SOLD VIA 1031:

1. NET SELLING PRICE ....$__ 74,000___
2. Less: Mortgage Payoffs.................. - _44,000___(Refi from $14,000 to $44,000,
3. Equals: NET EQUITY......... =$__ 30,000___ **takeout $30,000 cash)**

THE INVESTOR IS EXCHANGING UP (IN PRICE) TO A <u>REPLACEMENT</u> PROPERTY:

4. Cost of Replacement Property............ $_120,000___
5. Less: New Mortgage Obtained............ - __90,000___
6. Equals: DOWN PAYMENT\EQUITY =$__30,000___

NOW THERE IS NO DOWN-DIFFERENCE IN EQUITIES = NO TAXABLE BOOT

7. > EQUITY - Relinquished Property $__30,000___
8. Less: EQUITY - Replacement Property -_ 30,000___
9. Equals: "BOOT" GAIN................. = **_NONE___**

By refinancing the relinquished property from $14,000 to $44,000 the net equities of both relinquished and replacement properties are now equal. You will now use all of the equity in the relinquished property as down moneys for a higher-priced replacement property. We now have a move-*up* exchange with no cash takeout during the exchange. This is a totally tax-free exchange. In the meantime, when you refinanced prior to the exchange, you pulled out $30,000 as tax-free refinance cash.

<u>AND-WATCH-THIS</u>*:* Now you have more tax-free cash to invest in other properties!

2. **REFINANCE TAX-FREE *AFTER* THE EXCHANGE**

You can accomplish the same by refinancing the replacement property after the exchange. Again as per example 4 (last section) at the closing of the replacement property you obtain a mortgage for $60,000 (instead of $90,000). Now the net equity of the replacement property is $60,000 which is equal to the net equity of the relinquished property. There is now no taxable boot. Next week refinance and take out the remaining $30,000 mortgage - TAX-FREE (and you can even do all of this with the *same* lender, explained later). Again the end result is no boot taxable income as summarized on the next page.

<u>NO</u> BOOT: MOVE-*UP* 1031 EXCHANGE - REFINANCE *REPLACEMENT PR*OPERTY WITH CASH TAKEOUT <u>AFTER</u> THE 1031 ROLLOVER

DATA ON <u>RELINQUISHED</u> PROPERTY BEING SOLD VIA 1031:

1. NET SELLING PRICE ....$__ 74,000___
2. Less: Mortgage Payoffs................... - ___14,000___
3. Equals: NET EQUITY......... =$___60,000___

THE INVESTOR IS EXCHANGING UP (IN PRICE) TO A <u>REPLACEMENT</u> PROPERTY:

4. Cost of Replacement Property............ $_120,000___
5. **Less: New Mortgage Obtained.......... - _60,000___(INSTEAD OF $90,000)**
6. Equals: DOWN PAYMENT\EQUITY =$_ _60,000___

AGAIN THERE IS NO DOWN-DIFFERENCE IN EQUITIES = NO TAXABLE BOOT:

7. > EQUITY - Relinquished Property $_60,000___
8. Less: EQUITY - Replacement Property - 60,000___
9. Equals: "BOOT" GAIN.............. = **NONE___**

Next week refinance and take out the remaining $30,000 mortgage - TAX-FREE!

WILL THE IRS CHALLENGE REFINANCING BEFORE OR AFTER A 1031?

Possibly? The IRS may challenge before cash-out refinancing as a step transaction of constructive boot income. In a private letter ruling (8434015), the IRS ruled that last-minute debt-restructuring designed to get cash out of a property can result in taxable gain to the extent of the cash received in such refinancing. However, the IRS position can be challenged. In one case such debt-restructuring was permitted at the last minute and the IRS acquiesced to this [*Garcia*, 80 T.C. 491 (1983)]. Also, keep in mind that IRS letter rulings are not law and only pertain to the individual taxpayer who requested them.

2 MILLION DOLLARS > TAX-FREE VIA A PRE-EXCHANGE REFI!

Fredericks owned a 305 unit apartment complex with a mortgage balloon payment coming due. Just a few weeks before the balloon payment Fredericks refinanced and took out just over $2 million in tax-free cash. Shortly thereafter he listed the apartment for sale. A buyer offered $9,180,000. Fredericks accepted the offer providing the buyer would cooperate in a 1031 exchange. Since Fredericks already had 11 acres of land under an option to buy, where he desired to build business-type property, he decided to do a 1031 tax-free exchange. The IRS argued Fredericks had over a Million dollars taxable gain from the refinancing and sale. As a result he would have owed over $255,000 in taxes, interest & penalties.

VICTORY! Fredericks took the case to US Tax Court. The Court held that a $2 million refinance before an exchange was *not* boot income because the refi was independent of the exchange and Fredericks used a Qualified Intermediary. [*Fredericks* T.C. Memo 1994-27].

PROPOSALS TO LIMIT PRE-1031 REFINANCING NEVER PASSED

Moreover, the Proposed Regulations of April 16, 1990 addressed the issue of liabilities incurred "in anticipation of an exchange". The purpose here was to put some type of limit on refinancing at the time of an exchange. Fortunately this part of the proposed regs never become part of the final regulations as enacted in 1991.

TAX PLANNING TIP: To insulate against any IRS attacks, it is still safer to refinance *after* the exchange, instead of before. This is because for post-exchange refinancing there is virtually no authority. Moreover, there is more economic substance in that you will further remain obligated on post-exchange refinancing as opposed to last minute pre-exchange financing where the loan is paid off at the settlement of the relinquished property. Thus *post*-exchange financing is much more akin to tax-free refinancing than *pre*-exchange refinancing. It also helps to document an independent business reason for the refinancing and have a time delay between the exchange and the refinance.

Summarizing, refinancing before or after an exchange appears to remain in favor of you. Many 1031 experts believe that it also helps to have an independent business reason for the refinance, although if the refinance is done after the exchange, other experts do not see the need for such a business reason. Many also believe that there should be a reasonable time delay between the exchange and the refinance. Again, if the refinance is done after the exchange, others do not see the need for much of a delay in time.

{COMMENT: It could be helpful if you can both document a business reason for the refi and effect a time delay between the exchange and refi. It is not certain what a good business reason is. Perhaps the need for capital to effect property improvements would be a good one. What’s a reasonable time delay is also not certain. Waiting to the next taxable year to do the refi is frequently believed to be a prudent time delay}.

FINANCING TIP - HOW TO AVOID DUPLICATE LOAN COSTS:

Obtaining mortgages involves additional costs. In the scenario where you want to refinance shortly *after* a move-up exchange to achieve a tax-free cash takeout, you should first obtain a low or no cost short-term loan (such as a credit line or bridge loan) to initially acquire the replacement property. Subsequent to this, you could then obtain a higher permanent mortgage to payoff the short term loan and cash out for the balance. This should be done instead of obtaining two permanent mortgages which would incur more loan costs as opposed to a short term loan. Perhaps the seller of the replacement property would hold a short-term note on the property until permanent financing is acquired.

SAME LENDER: Alternatively, the short-term loan could be obtained from the *same* lender who will subsequently give the permanent (higher) mortgage. In this scenario, one could just apply for the full amount of the mortgage; draw out whatever amount they need at the settlement of the replacement property; and then at a date subsequent to the settlement take the remaining mortgage funds as a refinance cash takeout. This subsequent refinance cash takeout should be documented as a *separate* second closing with a *separate* settlement sheet titled *"REFINANCE"*.

RECOMMENDATION: USE A FRIENDLY TITLE CO. OR CLOSING ATTORNEY

You should select a title company or closing attorney who has at least some understanding of exchanges, but *more importantly* is cooperative in assisting you with your exchange. This is especially so about preparing 1031 exchange settlement sheets, especially when you will need special sheets for post-exchange refi's as discussed above. As far as title companies, on the buying side you do have the right to choose your own title company. Accordingly, you should select one that fits the above criteria. On the selling side your buyer (or their advisors) select the title company. However, you may be able to influence them to use the title company of your choice, especially if they are reputable and will come to the place of settlement. In many states, attorneys prepare settlement sheets. Again, you want to look for the same criteria and you can choose your own attorney to represent you at closing.

1031 TAX TIP: Refinancing before or after an exchange calls for advanced planning with a 1031 Exchange Tax Specialist. Call 1-800-351-1031.

{The next section tells you how to deduct the interest on the refi proceeds}.

VII. DEDUCTING THE INTEREST ON YOUR CASHOUT REFI?

IT'S NOT THAT SIMPLE - YOU NEED TO KNOW HOW!

While it's very advantageous to be able to extract tax-free cash from a 1031 rollover, it will also be very important to be able to deduct the interest on the refinance loan. Before 1987, deducting interest was not only more liberal, but was also much simpler. Save for a couple of exceptions, any type of interest was tax deductible with generally no limit on the amount of the deduction.

Today deducting interest is neither automatic nor simple. Under complex rules [IRC 163(h)] the tax treatment of interest can range from fully deductible to partially deductible to not deductible at all, depending on the category of interest. A list of these interest categories appears below. How the interest is deducted and the IRS form where it is deducted (for an individual taxpayer) is briefly stated in the brackets:

1. Qualified Residence Interest (Itemized deduction - Sch A)
2. Business Interest (Business deduction - Sch C)
3. Passive Activity Interest (Rental property deduction with possible limits - Sch E)
4. Investment interest (Stocks, bonds, etc. - Itemized deduction with possible limits - Sch A)
5. Consumer (Personal) Interest (<u>Not</u> deductible at all).

Except for category 1 (Residence Interest), the deductibility of interest will depend on on <u>how the loan monies are used</u> (and <u>not</u> the type of collateral-security used for the loan). Accordingly for categories 2 through 5, the deductibility (or non-deductibility) of interest depends on what you spend the money for. These rules are called "tracing" rules.

EXAMPLE 1: Ms. investor refinances her rental property and takes out $30,000 in cash which she uses to open up her own Realty company to be operated as a single proprietorship. The related interest on the refi loan is treated as category 2 - *Business Interest* - and is fully deductible as a business expense on her schedule C. It will not be deducted on Schedule E for rental properties, even though the security for the loan is a rental property. Had the loan funds been used for personal purposes, the interest is treated as category 5 - *Consumer (Personal) Interest* - and is NOT deductible at all. Again, it makes <u>no difference</u> that the rental property is the security for the loan.

EXAMPLE 2: Mr. I refinances his rental property and takes out $25,000 in cash to invest in stocks. The related interest on the refi loan is treated as category 4 -*"Investment Interest"* and is deductible up to the amount of investment income such as interest & dividends (unused deductions can be carried over). Again, it will not be deducted on Schedule E for rental properties, even though the security for the loan is a rental property. If Mr. I used a margin account to buy the securities, the interest would again be investment interest.

DO NOT COMMINGLE FUNDS: If you commingle the borrowed funds with your other unborrowed funds, then you can lose interest deductions on the loan. A full blown discussion of these rules is beyond our scope. Basically, what you need to do is to keep separate accounts for your business, rental properties, investments, and personal. Do NOT commingle borrowed funds with unborrowed funds. Try not to use the borrowed monies for personal expenditures. If you want to borrow to buy a personal-use item, make the purchase first from your savings account; then restore the savings account with the borrowed money. In this scenario, your savings account is an "investment" and therefore the loan interest is deductible as "*investment interest"* (which is better than being non-deductible personal interest).

EXCEPTION TO TRACING RULES - INTEREST ON SECURED HOME EQUITY LOANS UP TO $100,000 IS FULLY DEDUCTIBLE - NO MATTER HOW THE FUNDS ARE USED

Category 1 (*Qualified Residence Interest*) includes home equity loans on a principal or second residence. For home equity loans* up to $100,000 it makes NO difference how the funds are used. The related interest is fully deductible as residence interest which is an itemized deduction on schedule A of your 1040. (Loan funds beyond the $100,000 would come under the previously discussed tracing rules).

> ***ALERT**: For the home equity loan to be deductible as *"qualified* residence interest" the loan must be *secured* by your primary or second residence. Such security is accomplished by a mortgage or deed of trust. (Check with your RE attorney).

EXAMPLE 3: You take out a home equity loan for $100,000 on your residence. The loan is secured by a mortgage on your home. The money is used for the following purchases:

Home improvements............$ 20,000
Rental property...................... 50,000
Business equipment............... 10,000
To fund your Keogh Plan....... 10,000
Personal and recreational....... 10,000

Total..................................$100,000

The tax treatment of the related interest expense is fully deductible as residence interest on IRS form schedule A, *regardless* of how these loan proceeds are used. (Even the personal\recreation portion is deductible under this exception).

PLANNING STRATEGIES ON HOW TO SECURE INTEREST DEDUCTIONS IF YOU REFINANCE YOUR RENTAL PROPERTY:

1. Do not commingle funds. Where cash from the loan will be used for different purposes (such as business and investment), then you should keep the funds in separate accounts so the particular type of interest can be clearly identified.

For instance, you know you will be buying $25,000 of business equipment. Put the loan funds into your business account and send the check to the vendor. The same holds true for the purchase of stocks - open up a separate " investment account". For investment RE put the funds in your separate "rental account" and then purchase the RE. Use separate *non*-personal accounts for each purpose.

2. If you are uncertain where the refi funds will go, then *immediately* deposit them into a new separate (taxable) interest-bearing savings account.

Your savings account is an "investment" and therefore the interest is deductible as "*investment interest*".

3. Do NOT use the money to purchase or improve a primary or second home.

This is a *deadly* tax trap because if you do this, the interest will not be deductible at all. This is because you are using the monies for *personal* purposes and you cannot come under the residence interest exception as the loan is *not secured* by your primary or second home. It is secured by the rental property. TAM 9418001

4. Do NOT put the money in your *personal* bank account.

5. Do NOT make direct purchases of personal-use items (such as a fur coat).

6. Do NOT put the money into any type of *tax-exempt* securities (exempt bonds, exempt money markets accounts, etc.). The loan interest is not deductible.

7. Deduct Interest on Home Equity Loans Used for Business Purchases -- If you use a home equity loan for business purposes (such as the purchase of business equipment or a car) the interest can be deducted on Schedule A -- Itemized Deductions as home mortgage interest. However, if you use all or part of a home equity loan for your business, you can instead *elect* to treat the home equity interest as business and then deduct the interest as business interest on a business or rental schedule (not Schedule A). Deductions on these schedules are more valuable. To do this you must make a separate written election and attach it to your return, Reg. 1.163-10T(0)(5).

For a further discussion of the above (including the written election), refer to *The Real Estate Investor's Goldmine Of Tax Strategies*, Section 22.

1

USING 1031 MAGIC TO INCREASE SELLING & BUYING POWER

The wealth accumulation magic of 1031 exchanges allows little or no tax drain on equity. This means MORE SELLING POWER = MORE BUYING POWER. With 1031 magic, an investor can be a more *flexible* seller and a *substantial* cash buyer, which in turn gives the RE investor several important powers, which are the ability:

⇒ To sell quicker
⇒ To buy quicker
⇒ To obtain bank financing quicker
⇒ To obtain seller financing (which is quicker)
⇒ To buy all cash without any financing
⇒ To buy all cash and get discounts.

All of the above culminates into one significant power - the ability to create *Pyramiding Wealth Accumulation* in Real Estate acquisitions.

THE PROBLEM SCENARIO:

Our Real Estate entrepreneur is SM who owns a property that he will sell for $500,000. He owes $150,000 on the property and has gross equity of $350,000. Commissions & other selling expenses are $35,000, leaving him with a net pre-tax equity of $315,000. With his low tax basis the resultant tax liability would be over $100,000 (if he were to sell outright without 1031 Magic). In other words the net equity in the property of $315,000 would be reduced to $215,000 without 1031 Magic.

THE SOLUTION WITH *1031 MAGIC*:

SM's property is worth about $535,000. However he will sell it for $500,000. (By reducing the price he sells it *quicker*). He properly does the exchange with a qualifying intermediary (QI) escrowing the net cash equity of $315,000.

Via the 1031, he acquires a larger replacement property (with more rental units) for a price of $700,000. The seller holds the first mortgage of $420,000 and SM puts $280,000 down (from his net equity) as a substantial 40% down payment. The seller said she would not hold any financing unless there was at least a 40% cash down payment.{Without 1031 SM would have much less than 40% to put down. Thanks to *1031 magic*, SM fits the bill!}.

Because of seller financing, there are only $15,000 in closing costs (NO points, etc.). This leaves $20,000 in remaining tax-free cash equity which is to be used as power-play upgrades to enhance the value of the property. (This will be done via an "improvement" exchange, see section VIII-11). Because of the seller financing and the substantial down payment, settlement was held only 4 weeks after the executed purchase agreement.

The property was valued at about $900,000. However the seller was highly motivated & flexible with the above attractive terms (and again thanks to *1031 magic*). After doing the $20,000 in upgrades, the property was appraised even higher at $950,000.

The magic of 1031 has significantly enhanced SM's abilities to do the following:

⇒ To sell quickly and get into this much superior investment [the reduction in selling price by $35,000 is MORE than offset by the tax savings and the instant equity on the new property]
⇒ To obtain seller financing (= NO banks) because of the substantial down payment
⇒ To settle quickly
⇒ To upgrade the value of the property

The above translates into these *multiple* wealth accumulation benefits:

* Instant equity of $250,000
* Substantial savings in closing costs
* A larger property with *more* units = *more* cash flow = *more* value
* A higher priced property = higher depreciation deductions = additional tax dollars.

2

CONVERT NON-INCOME PROPERTY INTO

SPENDABLE CASH FLOW

THE PROBLEM SCENARIO: GF has raw land producing NO income NO cash flow and NO tax write-offs. With none of these, the land is a higher risk investment. GF will sell the land for $110,000, less commissions & selling expenses of $10,000. His net selling price is $100,000. His basis in the land is $20,000 leaving him an $80,000 gain which means, without 1031, he would have to pay taxes of about $24,000 on the gain. Because he owns the land free & clear, his net selling price of $100,000 is also his net cash equity of $100,000.

THE SOLUTION WITH *1031 MAGIC*:

THE REPLACEMENT PROPERTIES ARE 4 NEW TOWNHOMES: Through a qualified intermediary (QI), the $100,000 in cash is placed into a 1031 escrow account. Via 1031, GF rolls over the land (tax-free) into a 4 new townhomes acquired from a very motivated builder. The townhomes are $80,000 each or $320,000 for all 4 (including closing costs). Their present market value is $90,000 each but the builder needs cash and can afford to take a discount and even give GF some "optional upgrades" (including a homeowner warranty) at no additional cost.

TERMS\FINANCING With the net equity as a $100,000 down payment, GF will obtain a mortgage of $220,000 ($320,000 less $100,000) for 8%, 30 years with a (rounded) mortgage payment of $1615 per month on 4 units. The lending institution is a local "friendly" bank that does all of its own underwriting and portfolios many of its loans (including this one). Therefore, GF is not handcuffed with Fannie Mae restrictions. He talks to *directly* to "Mr. or Mrs. Jones" at the bank.

PROPERTY EXPENSES: Property taxes on each of the townhouses are $1500 a year or $6000 for all 4, or $500 *a month* for all 4 ($6000/12). Insurance on each townhouse is $250 a year or $1000 for all 4 or about $85 a month. Association fees are only $50.00 a month for each unit or $200 for all 4 units (the townhomes are direct fee simple and not condominiums). The units are brand new with repair warranties.

RENTS: There should be no vacancies. As a condition of the purchase agreement, the builder will rent two of the townhomes - one as a furnished sample model and the other as the sales office. The other 2 are to be pre-leased and occupied by settlement. With 3 bedrooms, 2-1/2 baths and many other modern amenities, they are very desirable and easily rent for $850.00 each or $3400 for all 4 units. Here are what the monthly numbers look like on all 4 units:

Rents (monthy all 4 units)		$3400
Monthy Investment:		
Mortgage payment (PI)	$1615	
Property taxes	500	
Insurance	85	
Association fees	200	
Total monthly outlay		$2400
POSITIVE CASH FLOW		**$1000** (per month)

[NOTE: Much of the above cash flow can be sheltered through depreciation and other property deductions. See the next section]

THE END RESULT FOR GF:

⇒ He totally (& legally) avoids paying $24,000 in taxes

⇒ From the get-go, he has *positive cash* flow income

⇒ Most (or all) of the cash flow can be *tax-free* income

⇒ He has *stable leases* with guaranteed rent on 2 of the 4 units plus NO vacancies

⇒ He has new *maintenance-free* properties with homeowner warranties

⇒ He has more potential for capital *appreciation* & wealth accumulation

⇒ He has more *diversification* with 4 units

⇒ He has substantially *reduced his risk*

⇒ He was able to close *quickly* within 45 days

⇒ He does it all with NONE of his own money

⇒ He can even take out *tax-free cash equity* via a post 1031 refi (see the next page*)

*CASH OUT REFINANCE AFTER THE EXCHANGE

For example, if the 4 townhomes are valued at $90,000 each or total $360,000, then 80% loan-to-value would be $288,000 less the mortgage balance of $220,000 leaves $68,000 of tax-free cash for GF. His mortgage payment would be about $500 a month higher. However, there still would be positive cash flow, more tax write-offs (with more interest) and GF has $68,000 TAX-FREE CASH to buy more high-yielding RE. As per our discussion on tax-free financing**, he could do all of this with the same (non-conforming) lender and save duplicated loan costs.

{**See Section VI, *HOW TO TAKE OUT TAX-FREE CASH FROM A TAX-FREE 1031 EXCHANGE and section VII on DEDUCTING THE INTEREST ON THE REFI}.*

3

USING 1031 MAGIC TO SHELTER POSITIVE CASH FLOW & TO AVOID "PHANTOM INCOME"

With 1031 exchanges you can increase your depreciation deductions by increasing the tax basis of your property. You can increase your basis if you exchange *up* in price. For example, you have a property with an adjusted basis of $30,000 and a net equity of $200,000. You decide to exchange up for replacement property at $500,000 using the $200,000 equity as your down payment and leverage by obtaining a $300,000 mortgage. Your basis in the new property would be:

Adjusted basis of the property exchanged	$ 30,000
Plus: the new mortgage	300,000
= Total basis of replacement property	$ 330,000

As it can be seen, the old basis has increased 11 fold! ($30,000 to $330,000).

EXAMPLE - USING 1031 TAX MAGIC & DEPRECIATION DEDUCTIONS TO SHELTER CASH FLOW: In the last example, G.F.'s positive cash flow (before taxes) is $1000 per month. Much of this cash flow can be sheltered through depreciation (and other property deductions). G.F. astutely exchanged up from a $110,000 property to $320,000 worth of property (an "up" difference of $210,000). The new tax basis of the 4 townhomes will be $240,000 (which is the total cost of $320,000 less the deferred gain of $80,000. Another way to compute the $240,000 basis is to add the $210,000 increase in value and the $10,000 selling expenses to the old basis of $20,000. Even another way to arrive at the $240,000 would be to add the $220,000 new mortgage to the $20,000 old basis. (See Section V for more examples of basis computations).

ALLOCATING THE BASIS FOR DEPRECIATION - Assume the following:
Of the total tax basis of $240,000, GF uses $10,000 for non-depreciable land value, $36,000 for "land improvements" (depreciated over 15 years) and the remaining portion of $194,000 for the building (depreciated over 27-1/2 years). The result is annual depreciation deductions of approximately $9450 shown on the next page:

PROPERTY COMPONENT	COST	PERIOD	DEPN DEDUCTIONS
Land Improvements*...........	$ 36,000	15 yrs	$2,400*
Building improvements........	194,000	27-1/2 yrs	7,050
Land	10,000	None	None
Totals..................................	$240,000		**$9,450**

The total $9450 depreciation divided by 12 months equals $788 a month in tax deductible depreciation that could be deducted against the monthly cash flow of $1000. The remaining $212 cash flow could be further sheltered through other *overlooked* rental property deductions such as office expenses, home office, telephone, travel, tools & supplies, family on payroll, family fringe benefits, seminars, publications etc. {Note: Generally, the $212 cash flow is also passive income that can be offset by unused passive losses}.

NOTES ON DEPRECIATION DEDUCTIONS:

* LAND IMPROVEMENTS - A very much overlooked property deduction is the depreciation write-off on land improvements which include landscaping, shrubbery, sidewalks, pavements, parking lots, curbs, non-municipal sewers, fences, docks, and bridges - depreciated over a recovery period of 15 years. An accelerated method is also permitted and can generate larger write-offs in the early years of the asset. Just about every parcel of real estate has to have such depreciable land improvements.

THE COMPONENT METHOD IS BACK IN A MODIFIED FORM

There is a costly misconception out there that you are not allowed to componentize a rental property for depreciation write-offs. This is not correct. The Tax Reform Act of 1986 brought in eight MACRS classes, 3, 5, 7, 10, 15 20 years, whose class lives are derived from the IRS's Asset Depreciation Range (ADR) system. There is also 27-1/2 years for residential real estate and 39 years for non-residential real estate. Pertaining to real estate, from the above classes are the following components:

- PERSONAL PROPERTY** (5 years - Straight-line or accelerated)**
- LAND IMPROVEMENTS (15 years - Straight-line or accelerated; see above)
- BUILDING IMPROVEMENTS (27-1/2 or 39 years - Straight-line only)
- MUNICIPAL SEWER PIPES (20 years - Straight-line or accelerated)
- LAND (non-depreciable)

****ALERT ON ALLOCATION OF NON LIKE-KIND PERSONAL PROPERTY:** In a 1031 exchange, the like-kind real replacement property allocations toward personal property (appliances, furniture, carpets, etc.) should be kept to a minimum and, if at all possible, none at all. This is because in a like-kind *real* property exchange, personal property received can be taxable boot. (But see tax planning tip 1 on the following page).

<u>TAX PLANNING TIP 1:</u> You can reap high depreciation deductions from such personal property items and still not cause any boot income. The way to do it - is to purchase the personal property from funds *separate* from the 1031 exchange, such as your own funds, credit card or a *separate* loan. Such personal property should be in an agreement (or bill of sale) *separate* from the real property.

<u>TAX PLANNING TIP 2:</u> The manner of component allocation for the new replacement property can be different than that of the old relinquished property. Accordingly depreciation deductions can be increased with more favorable and creative allocations with the replacement property. Check with competent tax counsel.

<u>TAX PLANNING TIP 3:</u> Although not required, it is recommended that component allocations be broken down in the purchase\sale agreements {with any personal property in an agreement (or bill of sale) that is *separate* from the real property }

<u>TAX PLANNING TIP 4:</u> For the most comprehensive discussion on how to double and triple depreciation deductions via componentizing, refer to *The Real Estate Investor's Goldmine Of Tax Strategies*. There are ten chapters and two appendixes just on maximizing those valuable depreciation deductions.

USING 1031 MAGIC TO AVOID "PHANTOM INCOME"

"Phantom income" is *non*-cash ("paper") income that is still subject to tax. That is, even though you received no cash you still have to report it has taxable income.

Not only can phantom income occur on the disposition of property, but it also can occur during the operations of the property when principal mortgage payments exceed depreciation. Because it is not tax deductible, the principal portion of the mortgage is in effect taxable income. Generally depreciation deductions exceed principal reduction and there is often a "tax loss". However when the property is owned for a number of years this process can begin to reverse (especially where an accelerated depreciation method is used). As each year passes the principal portion becomes larger while the depreciation deduction becomes smaller and eventually terminates. The phantom income occurs at the point where the principal portion of the mortgage exceeds the depreciation deductions. (This point is sometimes referred to as the "tipping point"). Thus the taxable income from the operations of the property exceed the cash flow. The difference in the higher taxable income and the lower cash flow is phantom income.

REFINANCING CAN SOLVE THE PROBLEM - One way to avoid this type of phantom income is to refinance the property with a new mortgage and take out cash. The cash takeout is tax-free and depending* on how the refi proceeds are used, the higher interest portion of the mortgage *may** again shelter the property income.

> [*NOTE: Whether the interest will be deducible (or not) will depend on how you use the refi proceeds. See Section VII on how to deduct this interest].

1031 MAGIC CAN EVEN BE BETTER

Refinancing has its place. However, as it was illustrated in the previous example (with G.F.), you can accomplish the same thing with a 1031 tax-free exchange....but even do *better*. Besides increasing your interest deductions with a new mortgage, a 1031 tax-free exchange can also provide the following benefits:

* INCREASE IN BASIS - By exchanging "up" in value, 1031 rollovers can increase your tax basis for higher depreciation deductions. Refinancing in itself does not increase the basis of the property (unless the proceeds are used for capital improvements on the property or to buy other real estate).

* HIGHER USE OF EQUITY - With 1031 exchanges you *maximize* your equity because you are not limited by lower loan-to-value ratios and you are not paying taxes on the sale\exchange. Moreover, with refinancing, lenders are sometimes more conservative on their appraisals on refinances than they are for sales. The combination of limited loan-to-value ratios and conservative appraisals means less cash equity that you can take out of the property.

* HIGHER YIELDING PROPERTY - With a 1031 exchange because you have more maximum use of your equity, you can rollover into superior yielding property (or properties).

<u>1031 TAX TIP</u>: It is a great idea to *combine* 1031 rollovers and refinancing because under present law refinancing can also be done before or after (not during) a 1031 rollover. This can be a way to generate tax-free cash and still qualify for 1031. {See Section VI, HOW TO TAKE OUT <u>TAX-FREE</u> CASH FROM A <u>TAX-FREE</u> 1031 EXCHANGE, also see section VII on deducting interest on the refi}

1031 MAGIC CAN ALSO SOLVE THE PROBLEM OF PHANTOM INCOME BY WAY OF A FORECLOSURE DISPOSITION

Phantom income can also occur on the disposition of the property through foreclosure. Again a 1031 exchange can avoid this. {See Section VIII-18, 1031 EXCHANGES AND FORECLOSURES}.

4

USING 1031 *MAGIC* AND *"NO MONEY DOWN"* TO DRAMATICALLY INCREASE YOUR EQUITY *PLUS* YOUR CASH FLOW

Properties that can generate more cash flow (and equity) are those that have the following:

* More rental units
* Higher rents (or higher potential for rent)
* Lower vacancy rates
* Lower property taxes
* Lower other operating expenses
* Lower mortgages payment
* Any *combination* of the above.

"LEVERAGE" is using other people's financial resources (such as a mortgage) to control more value and derive more profit. Leverage is also referred to as "OPM" or "Other People's Money". Frequently you can leverage 100% or with "NO Money Down". RE is the undisputed SUPERSTAR of leverage.

THE PROBLEM SCENARIO:

Mr. ED has 2 free & clear rental houses that throw off positive cash flow of about $18,000 a year, with limited or no potential for increase. Moreover the homes (for now) have peaked in value. The combined net selling price of the free & clear houses are $350,000. With a basis of $250,000 there would be a $100,000 taxable gain that would result in about $30,000 in taxes (with*out* 1031).

THE SOLUTION WITH *1031 MAGIC*: Ed sells the houses via 1031. Through a qualified intermediary (QI), the $350,000 in cash is placed into a 1031 escrow account. Via 1031 and combined with "*leverage*" ED rolls the houses over, tax-free, into a 54 unit apartment building generating much greater cash flow.

PRICE\VALUE - The apartment building is near foreclosure and is being acquired by ED for a price of $1,040,000 (and is worth at least $1,300,000).

- Presently the average rents per unit for the 54 apts. are a (below-market) $350 a month.

- Thus the total annual rents are $226,800 ($350 x 54 = $18,900 x 12 mos).

- In this location and for this type of building, average operating expenses and vacancies are about 40% of gross rents.

- This means that the net operating income (NOI) is 60% of gross rents of $226,800 or $136,080 in NOI.

- If we use the income-capitalization approach and capitalize this income of $136,080 at a cap rate of 10%, the value is $ 1,360,800 (over $1,300,000). (Presently, 8% is frequently being used on apartments similar to these).

LEVERAGE\TERMS - With closing costs at about $52,000, the total acquisition cost is $1,092,000 (1,040,00 + 52,000). The existing lender will gladly let ED assume the existing 9% mortgage of about $652,000. ED would like to put in another $62,000 to upgrade the building and then raise rents & increase the value. The total cash outlay is summarized as follows:

Below-market purchase price	$1,040,000
+ Closing costs....................	+ 52,000
= Total acquisition cost........	$1,092,000
Less: Mortgage assumption..	- 652,000
= Cash Downpayment..........	= 440,000
+ Upgrade Improvements.....	+ 62,000
= Total cash needed.............	= 502,000
Less: ED's cash equity.........	- 350,000
= Net Cash Needed............	= 152,000

"NO MONEY DOWN" IS FOR REAL WITH 1031 MAGIC

- Of course ED wants to do this with NO money down.

- Because of the property's higher appraised value, ED (through the power of negotiation) is able to convince the anxious bank into lending him the additional $152,000 cash needed to acquire the property and do the valuable upgrades.

- The lender consolidates the $652,000 existing mortgage and the $152,000 new mortgage as one first $804,000 mortgage at 9% , 30 year term (8 year balloon).

- The ADS or annual debt service (annual mortgage payment) is $77,630, which if we subtract from the NOI of $136,080, we arrive at an annual positive (pre-tax) cash flow of $58,450.

- With this kind of cash flow and with an current appraised value of $1,300,000 the lender still would be safe with Ed having substantial equity in the property.

WITH INCOME-PRODUCING PROPERTY, YOU PROFIT DRAMATICALLY BY PULLING A *"DOUBLE PLAY"* - YOU INCREASE CASH FLOW INCOME ***AND*** YOU INCREASE VALUE

♦ In about a year, as a result of the upgrades and below market-rents, ED is able to raise the rents on the 54 units an average of $50.00 per month per unit which equates to a total additional $2700 a month or $32,400 INCREASED cash flow income.

♦ Add the $32,400 increase to the present cash flow of $58,450 now ED has $90,850 in cash flow.

♦ Moreover, if we use the income-capitalization approach and capitalize this additional income of $32,400 at a cap rate of 10%, ED has also raised the value of his property by $324,000 ($32400/.10).

♦ Now the total investment value is $1,624,000 ($1,300,000 plus $324,000).

NOTE: At the present time higher quality apt. buildings (such as this one) are selling at 7 or 8% cap rates. Using 8%, the additional value increase would be $405,000 ($32400/.08), raising the total value to a whopping $1,705,000 ($1,300,000 + $405,000).

♦ For now we will use the more conservative value of $1,624,000 and subtracting the $804,000 mortgage, ED has equity of $820,000.

THE OVERWHELMING RESULT FOR ED IS THAT HE:

⇒ Totally (& legally) avoids paying $30,000 in taxes

⇒ Has increased his yearly cash flow by *5-fold* from $18,000 to $90,850

⇒ Can shelter (at least partially) cash flow income, with a higher tax basis

⇒ Has *more than doubled* his equity from $350,000 to $804,000

⇒ Can take out *tax-free cash equity* via subsequent refinancing

⇒ Does it all with NONE of his own money.

In the next section, we will see that ED could also use cash investors as another form of the power of leverage.

5

1031's & *MORE* "LEVERAGE"

USING CASH INVESTORS TO ACQUIRE REPLACEMENT PROPERTY

Using private cash investors to acquire real estate has many advantages - less costs, less red tape, less banks to deal with, quicker cash, etc. In the last example, as an alternative to using the lender for the additional $152,000, ED could have brought in a private investor as a CO-venturer. However with such an arrangement, there are two important issues that must be addressed regarding the technical requirements of the exchange:

(1) A PARTNERSHIP INTEREST IS NON-LIKE KIND PROPERTY - If you will be acquiring a partial interest in the replacement property with another party, your joint arrangement with this party cannot be a "Partnership" for income tax purposes. This is because a "partnership interest" is non-qualifying property for a 1031 exchange, IRC 1031(a)(2)(D). However, a tenant-in-common interest does qualify, Revenue Ruling 73-476. Therefore, your arrangement will have to be a "CO-Tenancy" and not a partnership. Each CO-tenant is to report their respective share of rents and expenses on the applicable schedule of their individual tax returns (usually page one of IRS schedule E). DO NOT FILE A PARTNERSHIP TAX RETURN (IRS Form 1065 & K-1's). Your 1031 specialist and tax advisors should ascertain that this is done properly.

(2) IF YOU WANT TO TOTALLY DEFER THE TAX ON THE GAIN , THEN YOUR PARTIAL CO-TENANCY INTEREST IN REPLACEMENT PROPERTY MUST EQUAL OR EXCEED THE *NET SELLING PRICE* OF YOUR RELINQUISHED PROPERTY - To totally defer the tax on the gain, you must invest in replacement property a minimum amount that equals or exceeds the *NET SELLING PRICE* of your relinquished property. *"Net Selling Price"* is the total sales price less commissions and other selling expenses. Thus your partial interest in the replacement property must equal or exceed this *NET SELLING PRICE*. If it is less, then all or part of your gain can be taxable boot {For a further discussion of these rules, see Section V}.

<u>1031 TAX TIP</u>: A way to bypass both of the above issues, is to have your Co-investor not be an *equity* owner. They could have a creditor position and just lend you the money for a return (which could still be a share of the profits). If they are not an owner, then there is no need to worry about either the partnership or minimum reinvestment issues. After the requisite holding period of 1 or 2 years, then they could then be converted to an equity owner if you so desire.

EXAMPLE: USING A PRIVATE CASH INVESTOR

In our last example ED leveraged by borrowing the $152,000 cash needed. Leverage can also be attained by using cash investors. Assume ED either cannot or does not want to borrow the $152,000 but instead secures it from a private cash investor - "NED" - who is presently getting about 3 or 4% at his local bank.

- If ED wants NED to be an equity owner, then their arrangement must be a Co-Tenancy and <u>not</u> a partnership.

- ED still has enough of a minimum reinvestment in the replacement property. The net selling price of his relinquished property was $350,000.

- His total acquisition cost of the apartment building is $1,092,000 less the $152,000 (NED's portion) equals ED's share of $940,000 which is well in excess of the $350,000.

- Alternatively, ED could just borrow the $152,000 from NED who would be in the capacity of a lender.

- With a debtor\creditor arrangement, then there is no need to worry about either the partnership or minimum reinvestment issues.

- Either way (equity owner or lender) there is plenty of income available in the property to offer NED a much greater return then low bank yields.

THE POSITIVE RESULT FOR ED: Through the power of *1031 magic* and *leverage*, he still does it with NONE of his own money.

<u>6</u>

USING 1031 MAGIC TO GET RID OF *PAIN-IN-THE-NECK* PARTNERS

Using private cash investors as either equity partners or lenders is a powerful way of using "*OPM"* - Other Peoples Money or *Leverage.* However, when you use such investors, you do not want them to become directly involved in the operations of the properties you will be acquiring. They are to have NO say in the management of the property. You want them for *one* thing and *one* thing only - CASH! You are the RE expert. You have the expertise to successfully *negotiate, acquire, finance, manage* and *market* RE investments that yield high returns. The private investor does not have this expertise. Therefore we have a perfect marriage - you with the *knowledge & skills* and the investor with the <u>cash</u>. *Combining* these resources can lead to excellent buys. However, sometimes we become involved with partners for imprudent reasons such as "It seems like a good idea" or "We have been friends along time" (You won't be for long!). The other know-it-all partners will have as much to say (if not, more to say) in the management as you do. When this happens, disputes frequently begin.

THE PROBLEM SCENARIO: This is what happen to Amy. Amy owns a partial tenant-in-common interest in a 4-plex (in a very good location) with two other (*"pain-in-the-neck"*) people. She wants to own properties by herself without anyone else telling her what to do. The net selling price of the property is $140,000. With a basis of $40,000 there would be an $100,000 taxable gain that would result in about $30,000 in total taxes (with*out* 1031). {Amy's one-third share of the taxes would be $10,000}. The existing mortgage balance is about $29,000 leaving a net cash equity of $111,000 ($140,000 less 29,000). {Amy's one-third share of the $111,000 equity is $37,000}.

THE SOLUTION WITH *1031 MAGIC*: They sell the triplex and go their separate ways. Through a QI, Amy's portion, the $37,000 cash equity, is placed into a 1031 escrow account. Via 1031 and combined with "*leverage"* she rolls her part co-tenancy interest, tax-free, into a 10 unit apartment building where she is now a *single* owner.

LOCATION: The property is located in a solid middle class (blue collar) neighborhood .

PRICE\TERMS: It is being acquired for $175,000 with 20% down ($35,000) and an 80% LTV mortgage of $140,000 to be carried by the seller.

LEVERAGE: With closing costs of only $5000, and a DP of $35,000 the total cash required is $40,000, less the $37,000 net equity leaves *only $3000* out-of-pocket for Amy.

INSTANT EQUITY: The property shows a net operating income (NOI) of $22,000. Capitalizing the present income of $22,000 at a cap rate of 10%, the value is $220,000 vs. the total cost of $180,000 equates to instant equity of $80,000 ($220,000 less the mortgage of $140,000). {And this is before any rent increases}.

POSITIVE CASH FLOW: The property shows over a $500 a month positive cash flow (again before rent increases).

TAX SHELTERED: Because Amy significantly exchanged *up*, she has a higher basis of over $146,000 which will enable her to shelter most of the positive cash flow.

[REMINDER: A "partnership interest" (where partnership IRS forms are filed) is <u>not</u> like-kind property and ineligible for a 1031 exchange. However, a tenant-in-common interest does qualify [IRS Revenue Ruling 73-476]. Amy & her co-owners never filed partnership IRS forms (IRS Form 1065 & K-1's). Each Co-owner reported their respective share of rents & expenses on the applicable schedule of their individual tax returns (page 1 of IRS schedule E). Accordingly, Amy accomplished a *qualifying* 1031 *tax-free* exchange as opposed to a taxable sale. She did use a *full service* QI].

THE POSITIVE RESULT FOR AMY:

⇒ Amy legally avoids paying taxes on the exchange of per partial interest
⇒ She now has *more cash* income *and* equity
⇒ But no more *"pain-in-the-neck"* partners
⇒ With a higher tax basis, a good portion of the cash flow can be *tax-free* income
⇒ She did it all with little of her own money.

The other two dopes don't do a 1031 and they get nailed on April 15th!

7

COMBINING 1031 *MAGIC* & SINGLE FAMILY HOMES TO *DIVERSIFY* YOUR PORTFOLIO

THE PROBLEM SCENARIO:

In section VIII-2, we already have the seen the power of Single Family Homes (SFH'S). Let's look at another scenario. K.H. owns a SFH (free & clear) in a location that he believes has peaked in value. The free & clear property will net $100,000 after commissions and other selling expenses. The SFH is fully depreciated and with just $10,000 in the land basis, the gain of $90,000 would result in taxes of about $27,000.

THE SOLUTION WITH *SFH MAGIC*:

SFH's are one of the safest investments with many advantages:

* All kinds of price ranges
* Appreciation potential
* High rental occupancy
* More diversification
* Less management
* Less complicated.

Moreover, SFH's are the easiest type of property to buy, sell, rent, manage, and finance. With properly structured leases, all utilities and most maintenance can be passed to the tenants. They can be the *residential version to triple net lease* commercial properties (see section VIII-10). SFH's generally involve less complexities such as a battery of attorneys, complicated settlements, environment audits, rent control laws, etc. There is *magic* with SFH's. They are like little pieces of clay that you can mold into different shapes that can give you much diversity such as:

⇒ You can *flip* them

⇒ You can *rent* them

⇒ You can *lease\option* them

⇒ You can *equity-share* them

⇒ You can *sell* them via an *installment sale* contract

⇒ You can *section 8* them for guaranteed government rent payments

⇒ You can *"package"* them as investments

⇒ You can *control* them better

⇒ You can *1031* them - TAX-FREE!

NOW IT'S TIME FOR 1031 *MAGIC*:

K.H. knows all of this and wants to expand & diversify his portfolio of SFH's. Through a QI, the $100,000 in cash is placed into a 1031 escrow account. Via 1031 and combined with leverage, he rolls the one SFH into *3* SFH'S that he acquires for a combined below-market price of $300,000 (including closing costs) in a potentially growth area. His $100,000 net cash equity from the old house covers it ALL - the total down payment, closing costs and costs to upgrade them into first class homes. From a local bank, his mortgage has very attractive terms at 8%, 30 years.

◊ SFH 1 is a brand new sample-model townhome that he leases back to the builder for 2 years with a positive cash flow.

◊ SFH 2 is a row house in and up coming urban area and is rented via a 2 year lease-option with a strong positive cash flow (because of the lease-option).

◊ SFH 3 is a single home and is rented with a 3 year lease with escalation clauses There is also an option to buy at any time during the 3 years

The new tax basis of the 3 SFH's will be $210,000 (which is the total cost of $300,000 less the deferred gain of $90,000). This will yield higher deductions.

THE POSITIVE RESULT FOR KH:

⇒ K.H. legally avoids paying taxes of $27,000

⇒ K.H. now owns 3 SFH'S instead of one

⇒ Plus they are at least 3 times more valuable than his old property

⇒ They have more appreciation potential

⇒ With strong rental arrangements, he still has a stable positive cash flow*

⇒ With a significant increase in basis he has increased his depreciation deductions.

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*<u>**TIP**</u>: An important ingredient of SFH investing is using the right lease. Standard leases are generally inadequate and can *cost* you. Great leases rid of you bad tenants and save you hundreds, even thousands, of dollars.

8

USING 1031 MAGIC ALONG WITH CASHOUT REFI'S TO EXPAND YOUR BUSINESS & *INCOME*

THE PROBLEM SCENARIO:

G.B. is a CPA and owns an office building that is becoming inadequate for his expanding accounting practice. The property will sell for a net selling price of $300,000 and has a low basis of $50,000. With a $250,000 gain, an outright sale would result in a substantial tax liability. The property has a $100,000 mortgage on it, leaving G.B. with a net equity of $200,000. G.B. also needs more working capital to continue expansion of his practice.

THE SOLUTION WITH *1031 MAGIC*: G.B. engages a full service QI to do a 1031 rollover. With the assistance of a Realtor-buyer's agent, he finds another office building which is larger and more suitable for his needs. The total cost of the replacement property is $400,000 with $150,000 for down monies (including closing costs) along with a 250,000 mortgage. The $250,000 mortgage is $50,000 more than he needs in cash down. Therefore the additional $50,000 will be taxable boot summarized below:

DATA ON <u>RELINQUISHED</u> PROPERTY BEING SOLD VIA 1031:

1. NET SELLING PRICE ....$ 300,000
2. Less: Mortgage Payoffs................... - 100,000
3. Equals: NET EQUITY......... =$ 200,000

DATA ON <u>REPLACEMENT</u> PROPERTY BEING ACQUIRED VIA 1031:

4. Cost of Replacement Property............ $ 400,000
5. Less: New Mortgage Obtained.......... - 250,000
6. Equals: DOWN PAYMENT\EQUITY =$ 150,000

THE *DOWN-DIFFERENCE* IN EQUITIES RESULTS IN BOOT AS FOLLOWS:

7. > EQUITY - Relinquished Property $ 200,000
8. Less: EQUITY - Replacement Property - 150,000
9. Equals: "BOOT" GAIN.............. = 50,000 (taxable boot income)

MORE 1031 MAGIC TO THE RESCUE

In order to avoid the taxable boot of the $50,000, G.B. (with the advice of his 1031 Exchange Tax Specialist*) does the following:

⇒ Goes to a friendly (non-conforming**) lender and applies for a $250,000 mortgage at 8%, 30 year fixed (10 year balloon). As part of the loan terms GB can make two draws on the mortgage, one for $200,000 to acquire the replacement property and the other for $50,000 to cash out with.

⇒ He engages a friendly title company for the replacement property settlement.

⇒ At the settlement of the replacement property he draws on $200,000 of the $250,000 mortgage and uses all of the $200,000 equity in his old property as a down payment. The $200,000 mortgage and $200,000 cash equity exactly equal the purchase price of $400,000. As a result there is now no cash left over and therefore NO boot taxable income. The "1031 exchange" settlement sheet clearly reflects this.

⇒ The following week G.B. takes out the remaining $50,000 mortgage via a TAX-FREE refinance. The *"Refinance"* settlement sheet clearly reflects this (see section VI on tax-free refinancing).

*Although GB is a CPA, he is not a "1031 Exchange Tax Specialist":

**Non-conforming lenders do not sell their mortgages to the secondary mortgage markets (such as Fannie Mae). Instead they warehouse their mortgages. As a result they can be more flexible in their terms (such as multiple draws and cashout refis].

THE POSITIVE RESULT FOR G.B:

∗ G.B. is able to continue to *expand his practice* with his new office building, *tax-free*.

∗ G.B. uses the $50,000 *tax-free* cash to *further expand* his practice (and income) in the way of new equipment, creative marketing, buying new clients, etc.

∗ The interest cost of the tax-free cash is only 8%

∗ The interest is *fully tax deductible* as a *business* expense, which means on an after tax basis (assuming a 30% tax bracket), the cost of the interest is really *less than 6%*.

9

USING 1031 MAGIC TO *FREE* YOURSELF OF MANAGEMENT

Because RE is so *diverse*, you can also own property with little or no management responsibility. Examples are:

- **TRIPLE NET LEASE PROPERTY -** The typical scenario here is a triple "A" commercial tenant responsible for all management & maintenance. On an average, these properties may yield about 8% to 12%. However, it can be a safe investment with little risk or management. {See the next section on TRIPLE NET LEASE PROPERTY}.

- **YOUR *DREAM* HOME IN THAT *DREAM* LOCATION -** The cost of many dream homes (including vacation homes) are beyond the financial capacity of many. However if you employ section 1031 and are not drained by taxes, you can have the full buying power to acquire a beautiful home beyond your wildest imagination.

  THE PROBLEM SCENARIO: D.W. has an old rental property and he is tired of the day-to-day tenant management

  THE SOLUTION WITH *1031 MAGIC*: He rolls it over into a Hilton Head condo.

  RESULT: Rid of day-to-day management, D.W. now has a *dream* come true.

  {See section IX. HOW TO USE THE 1031 EXCHANGE FOR YOUR DREAM HOME IN PARADISE - *TAX FREE}*.

- **OTHER TYPES OF PROPERTY THAT MAY REQUIRE LESS MANAGEMENT ARE**:

  * Garages
  * Mini-storage units
  * Parking lots
  * Ground leases (see section VIII-15)
  * Land
  * Single family homes (that are structured with creative leases and become the *Residential Version of Triple Net Lease Property;* (see section VIII-7)

OTHER WAYS TO REDUCE (or IMPROVE) MANAGEMENT ARE:

⇒ Engage a competent management company to manage the property.

⇒ Use a co-owner to manage the property (perhaps a younger family member).

⇒ Apply competent & creative management strategies.

⇒ Subscribe to "Mr. Landlord". Call 1-888-544-4636 or 1-215-937-9207.

⇒ Contact the "Institute of Real Estate Management ("IREM") at (312)-661-1953. (They have excellent publications related to RE management).

⇒ And try major book stores for RE management publications.

USING 1031 MAGIC TO INVEST IN BUSINESS PROPERTY THAT YOU ARE PRESENTLY RENTING

Another way to rid yourself of a management intensive property is to roll it over into business-use property that your are presently renting. As an entrepreneur if you had enough of a down payment, you could purchase the property you are presently renting for your business. Remember 1031 INCREASES buyer power. By employing section 1031, you can sell a presently owned investment property and use the tax-free equity to acquire business-use property as like-kind replacement property.

THE PROBLEM SCENARIO:

For a long time, Jean has owned a small apartment building in the state where she used to live. Now that she is far away it has become more difficult to manage the property (she prefers to manage it herself). She would like to sell but does not want to pay the taxes on the large gain, yet she does not want to reinvest into another apartment building She has her own consulting business that she operates out of a leased office condo that she has thought about buying but does not have the cash for a down payment. She needs her present cash resources for working capital in her business.

THE SOLUTION WITH *1031 MAGIC*:

Via 1031, she rolls over the apartment building into the office condo.

THE RESULT:

She is free of a *far-away* property and now owns her own office that she can decorate the way she wants...and she did it all *TAX-FREE.*

BY USING ANY ONE OR MORE OF THE ABOVE ALTERNATIVES, YOU CAN HAVE THE *BEST* OF ALL WORLDS:

⇒ Liquidate out of management

⇒ Stay in real estate

⇒ Avoid the tax-drain

⇒ Obtain greater after-tax yields

⇒ Effectively accomplish goals.

10

USING 1031 MAGIC FOR MANAGEMENT-FREE PROPERTY

TRIPLE NET LEASE PROPERTY

Here we have a long term lease with a triple "A" commercial tenant* with excellent credit. The tenant pays for almost all operating & maintenance costs and you receive a net rent check. Typically the tenant will pay additional rent for all increases in operating expenses including property taxes and insurance. The lease can provide for escalation clauses based on a common index such as the Consumer Price Index (CPI).

Triple net leases have the *low risk\ stable income* attributes of a grade A bond (it's like clipping coupons). However, even better than a bond it has the *upside potential* of RE because income will increase with the index, while operating expenses will remain fairly constant. Risk is minimal. Moreover, part or all of the net income can be sheltered from taxes via depreciation deductions. On an average, these net lease properties may yield about 8% to 12%, *after*-tax. However, it can be a safe investment with little or no management (and much a better after-tax yield than a *taxable* CD!).

*Examples of top triple net lease tenants are *WalGreens, Staples, Bell Atlantic, Sears,* federal & local government agencies, universities, hospitals and other well established companies.

[ALERT: If too much of the burdens of management, leasehold improvements and capital expenditures are passed on to the tenant, the lease transaction may be deemed to be a "sale". If this were to be the case the deferred 1031 gain would become a taxable gain triggering the tax liabilities. Competent tax counsel should be sought].

EXAMPLE - TRIPLE NET LEASE PROPERTY

THE PROBLEM SCENARIO: Jean and Bob have had a management intensive apartment building for many years. While they have profited from it, it was now time to slow down.

THE SOLUTION WITH *1031 MAGIC*: They rollover their apartment building (tax-free) into a *management-free* triple net lease commercial property which has prime tenants, generating a 12% cash return.

RESULT: They now have more time for fun & travel and tax-free income for retirement.

EXAMPLE - TRIPLE NET LEASE PROPERTY

THE PROBLEM SCENARIO

For many years, A&A have owned a 100-unit apartment complex in Delaware. While it has been very profitable for them, they are tired of the day-to-day management of the property. They would like to retire and move to Miami Beach, Florida. However, as long as they hold the apartments, they must stay nearby because of the management responsibility. Moreover, A&A have personally guaranteed the debt on the complex and want to relieve themselves of the personal debt. They therefore want to sell the property. However, if they sell the property (outright) they would have a substantial gain. The result being that they would be liable for taxes of over $665,000 which would leave them with net proceeds after debt repayment, brokerage commissions and other closing costs of about $530,000. They are presently receiving $100,000 in cash flow after-tax. They are astutely aware that they will not be able to safely invest their $530,000 in cash proceeds after sale and earn $100,000 after-tax (or an 18.8% return, tax free). They have a definite problem. In addition, they are beginning to review their estate planning and do not want to leave a management intensive asset (with personal debt) to their children.

THE SOLUTION WITH *1031 MAGIC*:

A&A approaches their commercial real estate counselor with the problem. The counselor (along with a 1031 tax specialist) advises them to begin planning for a 1031 exchange. The counselor recommends that they roll over into a 25 year triple-net-leased property for $7,495,000 by using their pre-tax net equity of $1,195,000 and by obtaining a 6,300,000 non-recourse* mortgage.

{*Note: A "non-recourse" mortgage is where the debtor is not personally liable on the debt. The most the debtor could lose is their equity investment}

THE POSITIVE RESULT FOR A&A:

⇒ They have legally avoided the tax drain on the sale of the apartment building

⇒ After the 1031 exchange, A&A will earn a greater after-tax return on their new investment

⇒ They will be building up equity each year as their debt service amortizes principal

⇒ As equity builds up, A&A may have the ability to refinance the property and pull out *tax-free* cash (which they can reinvest further)

⇒ At the end of the 25-year lease term, they will own the property *free & clear*

⇒ Upon their death, the property will pass to their heirs with a stepped-up basis, eliminating the income tax liability forever

⇒ They are free of personal debt

⇒ They are relieved of management responsibility

⇒ Each month they go to their mail box in sunny Florida and just collect their net check!

BEST OF ALL WORLDS: Combined with a 1031 exchange, the triple net-lease property is a powerful option with the best of all worlds - *little or no management, high return, low risk, tax-free.*

RECOMMENDATION: With triple net leases - competent tax, legal and investment counsel should be sought.

11

CONSTRUCTION EXCHANGES

USING 1031 MAGIC TO ACQUIRE A PROPERTY THAT DOES NOT EXIST

Construction improvements to a replacement property can be part of a 1031 exchange.

THE PROBLEM SCENARIO: Jane owns a rental property that she wants to sell via a 1031 exchange. The Net Selling Price of her relinquished property is $200,000. With a tax basis of $100,000 she will have a $100,000 taxable gain (which would result in about $30,000 in taxes without 1031). As a replacement property, Jane has her eye on a beautiful water-front lot in a great location. However, the cost of the land is only $100,000. With a net selling price of $200,000 she will be short by $100,000, which will be taxed. Thus if she were to just buy the land it would not pay her to do the exchange. She would have to just bite the bullet. She could buy other replacement property to make up the down difference. However, such an acquisition does not fit in with Jane's personal goals (*we don't want the tax tail to wag the financial dog!*).

THE SOLUTION WITH 1031 MAGIC: In about 3 years Jane wants the replacement property to be her dream home in her dream location. The cost to build a home on the lot will be at least $100,000 which, when added to the $100,000 land, would bring her up to the minimum reinvestment of $200,000. She would then owe NO taxes. During the 3 year period Jane will rent the home to her sister (and there is nothing in the law from stopping Jane to visit "Sis" and stay overnight).

> NOTE: To do this properly, Jane's needs to follow the special rules of what is called a *"Build-To-Suit"*, *"Construction"* or *"Improvement"* Exchange {IRS Reg 1.1031k-1(e)}. These rules require the Qualifying Intermediary (QI) to take title to the replacement property until the improvements are completed (within 180 days) at which time the QI would then transfer the title of the replacement property to Jane. The improvements must be complete within the 180 exchange period. During this period the QI would authorize the construction disbursements. Construction exchanges are more involved (but feasible) and do require competent expertise.

THE POSITIVE RESULT FOR JANE:

⇒ She has a brand new home that she can visit during the rental period.

⇒ At the end of the rental period, she can make the home her primary haven.

⇒ She legally avoids paying $30,000 in taxes.

⇒ She accomplishes her *personal* goals as well.

AN "IMPROVEMENT EXCHANGE"

Instead of vacant ground, there are times where the replacement property is an existing building but needs to be restored or renovated. I have seen old, dilapidated buildings totally restored to their former splendor. Under these same rules, "build-to-suit" improvements can be done to the replacement property to bring its cost up to or greater than the net selling price of the relinquished property. In other words, we can convert a *taxable* move-*down* exchange into a *tax-free* move-*up* exchange.

PLANNING TIP: INSTEAD OF A "CONSTRUCTION OR "IMPROVEMENT EXCHANGE" HAVE THE OWNER OF THE REPLACEMENT PROPERTY FIRST DO THE IMPROVEMENTS BEFORE ANY PROPERTY TRANSFERS

If feasible, an easier alternative is to have the owner of the replacement property do the necessary real property improvements before any transfer of properties has occurred. You could then complete the exchange as you normally would within the required time limitations. This way would negate the need for a construction exchange.

EXAMPLE: In the example above, assume that Jane was dealing with a builder. The builder could retain title to the lot, build the home and within 180 days Jane could close on the completed ($200,000) home. Jane would still need a QI. However, structuring it this way would eliminate the need for a "construction exchange" and also the necessity of the QI taking title until completion of the construction.

This same strategy can be done for improvement exchanges. The seller could retain title to the property, do the improvements and within 180 days you could close on the improved property. (While the seller is holding title, you could even supervise the improvements just to make certain they are done in accordance with your needs).

TIP: Insert in your purchase agreement a clause that requires the builder (or contractor) to be responsible for federal and state tax liabilities in the event the exchange fails because the construction is not completed within the required 180 days. The dollar amount of the tax liability should be stated in the clause and should be used to reduce the purchase price, if the exchange fails as per the above.

12

CONSTRUCTION EXAHANGES TO YOUR OWN PROPERTY

<u>SCENARIO 1</u> -- IMPROVEMENTS ON YOUR OWN LAND: You own two separate properties - one a rental property and the other *un*improved property (such as land). You sell the rental property via the 1031 exchange as the relinquished property. The net proceeds are escrowed with a QI and within 180 days are used to erect a building structure as a replacement property on your presently owned unimproved property.

Does the constructed improvements (on your property) qualify as like-kind property in a 1031 exchange? At least in the past, the IRS has said no. [IRS private letter rulings 8701015, 8921058, and 9031015. See also *Bloomington Coca Cola Bottling Co*., 189 F.2d 14].

TAX LAW ANALYSIS - IRS' POSITION APPEARS TO BE ILLOGICAL!

Why? Because when explaining "like-kind" as being broad in nature, Regulation 1.1031 (a)-1(b) states: *"The fact that any real estate involved is <u>improved or unimproved</u> is not material, for that fact relates only to the grade or quality of the property and not its kind or class."* (underlined emphasis added). In other words it makes no difference if the property is improved or unimproved. It can be like-kind! Moreover, as part of the 1991* safe harbor regulations IRS allows the replacement property to be "produced" or constructed [Regulation 1.1031(k)-1(e) - see the last section, *Build-to-suit* exchanges]. Note that regulations have much more the force and effect of law than do IRS private letter rulings. *It is also interesting to note that the safe harbor regulations were enacted in 1991 *after* the above letter rulings. (Maybe the IRS attitude has changed?) Moreover, in the former Section 1034 rollover of a principal residence, construction improvements were permitted to be part of an existing replacement home [Reg. 1.1034-1(b)(9); IRS letter rulings 7814022 and 8548027].

Based on the above it appears that the intent of the tax law is to allow *any* improvements to qualify even if it is on property already owned by the taxpayer. Also remember, the IRS does not have the power to make tax laws. IRS letter rulings only pertain to the taxpayer who requested them. They are <u>not</u> law. Again, regulations [such as Regulation 1.1031(k)-1(e)] have much more the force and effect of law than do IRS private letter rulings. Nevertheless, until there is clearer guidance, doing this type of an exchange could involve the risk of any litigation expenses. On the other hand, along with any such possible risks, you also have to consider the amount of taxes involved as well as the current climate of fewer IRS audits.

UPDATE: IRS STILL SAYS NO! A planning idea to accomplish this type of an exchange was to use an "Exchange Accommodation Titleholder" (or "A.T.") in a parking transaction to reinvest the proceeds from the closing of the relinquished property into improvements on existing property already owned by the same taxpayer. But, effective July 21, 2004, IRS states that this parking arrangement does not apply if previously owned property is transferred to the AT and then transferred back to the taxpayer as replacement property. The treasury may impose further restrictions if it determines that such transactions are inconsistent with the like-kind exchange rules. (IRS Revenue Procedure 2004-51, 2004-33 IRB 294). This stinks! But will be too high of a risk to do the above type of planning idea with the AT.

PLANNING COMMENTARY: Is this to be assumed -- This restriction applies to property already owned in the taxpayer's *individual name*, but should not apply to a separate *entity* such as a corporation (even a related entity owned by the taxpayer)? I say yes.

Reasons: Internal Revenue Code Section 1031(f) prohibits doing a 1031 exchange between certain related parties and where one of the exchange properties is subsequently transferred before the end of 2 years. Here the exchange property is considered to be non-qualifying, non-like-kind property. But this also means that if the property is held for two years (or more) it is like-kind and you therefore can do an exchange with a related party (with the 2-year holding rule being met). For the purpose of IRC 1031(f), "related parties" are those defined under IRC 267(b) which includes *entities* such as C corporations, S corporations and trusts. Related parties are also those defined in IRC 707(b)(1) which includes partnership *entities*, presumably including two (or more) member LLC's. (Italic emphasis of *entities* added). Accordingly, if the taxpayer's property is already owned by such an *entity* then the above Revenue Procedure (2004-51) should not apply and the improvements to the *entity's* property can qualify as like-kind replacement property and a 1031 exchange. This is because the property is not owned by the taxpayer but owned by the *entity* which is separate and distinct from the taxpayer (even though the taxpayer may own all or some of the shares of the entity). Such entities include C or S corporations, partnerships, two (or more) member limited liability companies (LLC's), and irrevocable trusts. (**ALERT**: Single-member LLC's or revocable trusts would not be separate entities because they are disregarded for tax purposes. That is, for tax purposes, it's as if they don't exist. Thus, they probably would come under this restriction per Rev. Proc. 2004-51.)

PLANNING STRATEGIES WHERE THERE ALREADY IS A SEPARATE ENTITY:

1. Via a construction exchange with a qualified intermediary, the taxpayer should purchase the property from the entity as replacement property. The taxpayer then completes the exchange by doing improvements on the replacement property via a construction exchange. (See the previous section on build-to-suit or construction exchanges).

2. The terms of sales between the taxpayer and the entity should be as arm's length as possible. However, the taxpayer must keep in mind that with the entity selling this property if the entity (or its owners via K-1's) have too much of a gain, then it may not be worthwhile doing anything.

This will depend mainly on the tax liability on the entity's (replacement) property and even more so the tax liability on the sale of the other exchange property (the relinquished property). If the entity does sell the replacement property at a favorable price where there is little or no gain, then the sales price should be backed up an independent appraisal.

3. The sales documents should be arm's length using the same documents that are customarily used in the locale.

4. There should be an actual settlement and all applicable transfer costs should be paid.

5. To ensure the separateness of the entity from the taxpayer, employ the necessary entity formalities, such as annual minutes, entity identification on all documents, etc. (under competent legal advice).

POSSIBLE STRATEGY IF PROPERTY IS INDIVIDUALLY OWNED BY THE TAXPAYER: **Transfer the property to such an entity prior to the exchange and then follow the same steps as in the previous strategy**. But could the IRS collapse this as a "sham" or "step" transaction and thus disqualify the 1031 exchange? This seems to be uncertain. Accordingly, here are some planning techniques for this strategy:

1. Timewise, the transfer to the entity should be done as far before the closing of the relinquished property as possible, very preferably in the prior tax year. (Alert: There could be local transfer fees. Check this with a local attorney or title company.)

2. Document a good independent reason for the transfer such as estate planning or a business purposes such as the prestige of an entity like an LLC*.

3. Again, follow the same steps as in the previous strategy.

> **[*ENTITY TIP**: Taxwise, the best entities for real estate are LLC-partnerships or limited partnerships. Plus, they fit into this strategy. However, even though corporations fit into this strategy, try not use corporations because of their tax disadvantages for real estate**]**.

SCENARIO 2 -- DEMOLITION & CONSTRUCTION: A second scenario involving construction improvements to the taxpayer's own property is this one -- The taxpayer owned a rental property. He transferred the deed of the property to a developer who demolished the structure and subdivided the land into two lots. The developer constructed two new townhouses and deeded one of the townhouses (with the underlying lot) back to the taxpayer in exchange for the lot with the other townhouse. The one lot and townhouse stayed with the developer as his compensation for the construction. Creative idea! Well in one letter ruling the IRS did allow it [PLR 8847042]. Unfortunately for some unknown reason, IRS subsequently revoked the above ruling with PLR 8921058. And now we have Revenue Procedure 2004-51.

PLANNING STRATEGY: Use the same strategies above; or look for other replacement property owned by others.

13

REVERSE "STARKER" EXCHANGES

- LET'S SHIFT GEARS AND GO IN REVERSE -

ACQUIRING THE REPLACEMENT PROPERTY *FIRST*

ACQUIRING THE REPLACEMENT PROPERTY *FIRST*

Sometimes in a 1031 transaction, the investment property owner (Exchangor) must acquire the replacement property *before* they close on their relinquished property. For you, the Exchangor, there can be any one or more reasons for this necessity:

⇒ You have not yet secured *a buyer* for your relinquished property.
⇒ You are *legally committed* to close on the replacement property and not to do so could mean loss of a substantial deposit or a suit for specific performance.
⇒ The replacement property is a *tremendous buy,* even a "steal" and the seller must sell ASAP (*You can't steal in slow motion!*)
⇒ The replacement property is in an *ideal location* for your business - you need it *ASAP*.
⇒ The replacement property is a *special-use* property that you must have in order to conduct your business. Otherwise there can be lost profits.
⇒ The replacement property is a *dream home* in a dream location & you *must* have it!
⇒ You just *want* the property - period**.**

Acquiring the replacement property, first, is known as a *Reverse "Starker" Exchange*.

THE IRS NOW CLEARLY PERMITS REVERSE STARKER EXCHANGES THAT ARE COMPLETED WITHIN 180 DAYS (REV. PROC. 2000-37)

Prior to Revenue Procedure 2000-37 authority for using reverse exchanges was not clear-cut. {See tax court cases - *Rutherford*, TC Memo 1978-505; *Lee*, TC Memo 19186-294; *Baird Publishing Co*. 39 TC 608, 1962}. However, effective September 15, 2000, the IRS in Revenue Procedure 2000-37, issued safe harbor guidelines for reverse exchanges. The intermediary company, who is called an "exchange accommodation titleholder" ("AT"), takes title to the replacement property from the seller and "parks" the property in their inventory until the relinquished property is settled with a buyer. Once a buyer is found for the relinquished property, the replacement property can then be deeded from the "AT" to the Exchangor. The relinquished property must be settled and the exchange complete within 180 days from the date that the replacement property is first acquired by the AT.

REVERSE STARKER EXCHANGES THAT ARE PAST 180 DAYS

As discussed above, Revenue Procedure 2000-37, has issued safe harbor guidelines for reverse exchanges. In the event that the above 180-day time requirement cannot be met, the above Revenue Procedure does state that reverse exchanges can be accomplished outside of this safe harbor. Accordingly, reverse exchanges can go longer than the 180 days. See next.

1031 exchange experts agree that the safest way to do a reverse exchange (especially those going beyond 180 days) is to restructure it as a *simultaneous* exchange (a "restructured simultaneous exchange"). *Reason*: The IRS safe harbor regulations for delayed exchanges are also permitted for *simultaneous* exchanges [Reg. 1.1031(b)-2]. Then the exchange would also come within the technical requirements of this safe harbor regulation [Reg. 1.1031(b)-2].

I have been doing it this way for years, long before the above Revenue Procedure. To accomplish we uses two different intermediary companies: One to take and transfer title to the Exchangor's replacement property. The first company is the "Exchange Accommodation Titleholder" or "A.T.", as previously discussed. The second company would act as the "Qualified Intermediary" ("QI") and perform only the functions of a QI under the IRS safe harbor regulations. (See Section IV for the role of the QI).

The "AT" takes title to the replacement property from the seller and "parks" the property in their inventory until the relinquished property is settled with a buyer. Once a buyer is found for the relinquished property, the replacement property can then be deeded from the "AT" to the Exchangor and the relinquished property deeded directly from the Exchangor to the buyer. Again, this is also done with a second company, the "QI", acting as the qualified intermediary as discussed above.

Thus, we have two *1031 exchange closings* which would occur on the same day as a *simultaneous* 1031 transaction:

> **Closing 1**: The sale\exchange of the *relinquished* property from the Exchangor directly to the buyer via the Qualified Intermediary ("QI").
>
> **Closing 2**: The acquisition of the *replacement* property by the Exchangor from the "AT" via the Qualified Intermediary ("QI").

Each of the above simultaneous closings should be documented by a settlement sheet (preferably a standard type HUD1). Both settlement sheets should have the *same** date. (The data from these settlement sheets would be used to prepare the 1031 tax reporting schedules.) This two-company approach clearly creates a 1031 exchange under the IRS safe harbor regulations.

> [***TAX POINTER**: If the Exchangor will be acquiring more identified replacement property, then this exchange can also be a delayed exchange up to the 180-day deadline which would begin from Closing 1 of the relinquished property. Here we would have a combination simultaneous and delayed exchange]

REVERSE EXCHANGE EXAMPLE: JJ owns an income property that he wants to sell via a 1031 exchange. JJ lists the property for sale with a Realtor and prudently engages a full service intermediary company to set up (in advance) all of the exchange procedures & documentation. In the meantime JJ unexpectedly comes across a great deal on a replacement property. The property owner is far behind in mortgage payments and is desperate to avoid foreclosure. JJ does some quick checking and makes a low all-cash offer which is quickly accepted by the distressed owner. JJ contacts the lender about holding off foreclosure. The lender agrees and while they are delighted to hear from JJ, they want to settle this fast (as does the owner). JJ has no choice, either do a reverse exchange or lose the deal. Fortunately JJ has already engaged a full service intermediary company who could easily set up the reverse exchange as a simultaneous exchange (as explained above). JJ decides to do it. The intermediary company uses two companies to do the reverse exchange: (1) The "Exchange Accommodation Titleholder" (or "A.T."), and (2) The "Qualified Intermediary" ("QI"). The AT acquires the replacement property and parks it until JJ finds a buyer for his relinquished property, which he does. At this time the AT deeds the replacement property to JJ and JJ deeds his property to his buyer as a simultaneous transaction. This is all done along with the second intermediary company that acts as the QI. Because of this exchange JJ ends up with a great buy, free of the drain of taxes.

REVERSE EXCHANGES - ISSUES THAT NEED TO BE ADDRESSED

Below is an overview of the some of the more important issues that need to be addressed.

1. 45\180 DAY TIME DEADLINES - As per the above safe harbor (Rev. Proc. 2000-37), reverse exchanges now have the 45\180 time deadlines beginning from the date that the replacement property is acquired by the AT (the "exchange accommodation titleholder").

TAX TIP: If you are going to be outside of the 180 day (and 45-day) safe harbor, then set up the exchange as a simultaneous exchange as previously discussed in this section. Under this arrangement, the premises is that this is a simultaneous exchange and that there are no time deadlines to meet (at least technically).

2. MANAGEMENT - COLLECT RENTS\PAY EXPENSES - While the AT is parking the replacement property, who will manage the property, collect rents, pay expenses? *Answer*: The Exchangor. There should be a "Management Contract" between the AT and the Exchangor where the Exchangor handles all of the management tasks of the property, including the collecting of rents and paying of expenses. [Note: This is permitted under Rev. Proc. 2000-37]

2A. TAX REPORTING OF RENTS & EXPENSES - The Exchangor (not the AT) reports the property rents and expenses on their IRS rental property schedule (such as Schedule E). However, the Exchangor does not claim depreciation during the AT's parking period of the replacement property. *Reason*: During this parking period it is not the Exchangor's property. The AT also should not claim depreciation, because the property is non-depreciable inventory. Thus, no one claims depreciation during the parking period.

<u>3. DUPLICATE TRANSFER FEES - *REPLACEMENT* PROPERTY</u> - In locales that charge transfer taxes (or "stamps"), there will be a first transfer tax when the AT acquires (and parks) the replacement property from the seller. There will be another transfer tax in the second transfer when the AT deeds the replacement property to the Exchangor as part of the simultaneous closings. However, this duplication of transfer fees may be avoided if the locale allows a "straw party" exemption (or other exception) on this second deed transfer. Another possible way to avoid duplicate transfer taxes is for the intermediary company **not** to take "legal" title to the property, but to take *equitable* ownership via a long-term lease or installment land contract. Check this with competent legal counsel.

> **<u>ALERT</u>:** Some 1031 experts take the position that if this is to be a true restructured simultaneous exchange with the AT as a "principal", then a second transfer tax should be paid by the Exchangor. Whether this is true or not is uncertain (as others do not totally agree). The decision to pay the transfer tax or avoid it (per an exemption) would also depend on the amount of transfer taxes versus the amount of income tax savings (via the 1031), and the Exchangor's willingness to take any possible additional risks with the IRS.

> **<u>TAX BREAK</u>**: However, if the exchange is completed within 180 days as per the above safe harbor (Rev. Proc. 2000-37), then the above should not be an issue and voluntarily paying a second transfer tax would be presumably not necessary.

Relinquished Property - Any duplicate transfer costs on the closing of the relinquished property can more easily be avoided by the Exchangor *deeding directly* to the buyer of the relinquished property. "Direct deeding" is permitted for regular types of exchanges. {IRS regulation 1.1031 (k) -1(g) (8) EG 4 and Revenue Ruling 90-34}. It is also permitted in this scenario of a restructured simultaneous exchange.

<u>4. LENDER COOPERATION</u> - Any lenders who are securing the replacement property with a mortgage (or deed of trust) must know about the AT's parking arrangement in advance because their cooperation will be needed. The lender will in all likelihood object to someone being on title other than the Exchangor as buyer\borrower. This objection can be overcome by explaining that a 1031 exchange is being done and that the lender will still be secured by the property along with the Exchangor's signature/guarantee as borrower. If the lender is agreeable, the AT should also be on the mortgage as a collateral non-recourse borrower.

ALTERNATIVES IF THE LENDER IS NOT COOPERATIVE:

- Use a property other then the replacement property as security for the loan.

- The AT does not go on the deed but acquires the replacement property by way of *equitable* ownership via an installment sale contract (or contract for deed). <u>Note</u>: This is permitted under Rev. Proc. 2000-37. However, as far as any legal issues, check with able counsel.

- Do a different type of restructured simultaneous exchange where the Exchangor would transfer the title of the Exchangor's *relinquished* property to the AT who would park it until it is sold to an actual buyer. This can be done by way of *equitable* ownership via an installment sale contract (or contract for deed). As far as legal issues, check with able counsel.

5. THE FUNDS TO PURCHASE - The funds for the AT's purchase of the replacement property are transferred from the Exchangor to the AT via a mortgage loan (see below*). That is, the Exchangor will send or wire the funds to the AT who in turn will use the funds to purchase the replacement property from the seller (or the seller's closing agent).

6. THE EXCHANGOR IS SECURED WITH A MORTGAGE - With the AT taking title to the property, the Exchangor needs to be secured. This is done by a mortgage (or deed of trust) on the property with the AT as mortgagor\borrower and the Exchangor as the mortgagee\lender. (*The mortgage also documents the Exchangor lending the AT the funds to purchase the replacement property for the parking transaction).

ALTERNATIVES TO REVERSE OR RESTRUCTURED SIMULTANEOUS EXCHANGES

To avoid a reverse exchange, the best and probably the only viable alternative is to postpone the closing of the replacement property until the relinquished property can be sold (settled). To convince the seller of the replacement property to extend the time for closing, you can do any one or more of the following:

1. Give an additional option deposit* (The more of a deposit, the more convincing)

***ADVANCED PLANING TIP**: The intermediary company should be engaged *before* paying (or receiving) deposits. The positive result is that right from the beginning, all deposits will go through the intermediary company and all documentation could be set up in advance in accordance with IRS 1031 requirements. Accordingly any trace of constructive taxable receipt should be eliminated.

2. Lease the property with rent payment@ enough to cover the seller's monthly cost

[**@TAX ALERT**: This should be a "pure lease" and not a lease-purchase. There should be no passing of the "burdens & benefits" of ownership. Check with able counsel].

3. Lend** the seller money to satisfy the seller's cash needs

4. Co-sign** a loan to the seller for money to satisfy the seller's cash needs (the loan could later be converted totally to the Exchangor and be used to buy the property).

**RECOMMEDNATION: Any loans, including co-signing on notes, should be done with the advice of a competent real estate attorney.

FINAL TIP: Consult with an intermediary company that has experience & expertise in reverse exchanges. Call *CESI* at 1-800-351-1031.

See the next section on *reverse-construction* exchanges.

13-A

REVERSE-CONSTRUCTION EXCHANGES

Before reading this section, it is recommended that you first read Section 11 on construction (or build-to-suit) exchanges and Section 13 on reverse exchanges.

A *reverse-construction* exchange is where the investment property owner needs to accomplish *both* a reverse and construction exchange into one exchange transaction.

The replacement property is acquired first by the intermediary company (called the "exchange accommodation titleholder" or AT). The AT takes title to the replacement property from the seller and "parks" the property in their inventory. During the parking period, the mechanics of a construction exchange are also accomplished. This entails AT holding title to the replacement property until the improvements are completed at which time the AT would then transfer the title of the replacement property to the Exchangor. The improvements must be complete within the 180 exchange period, unless you go pass the reverse exchange 180 day safe harbor as per Revenue Procedure 2000-37 (discussed in the previous section). But if in the meantime the closing of the relinquished property occurs, then the 180 day period would begin from such closing. The construction must be complete during this period. During this period the AT would authorize the construction disbursements.

Note that an AT is used because this is also a reverse exchange. As discussed in Section 13, another intermediary company should also be used to act as a qualified intermediary or QI. Special documentation must be used.

EXAMPLE: RC is selling a relinquished property for a net selling price of $800,000. The property has an adjusted basis of $200,000, realized gain of $600,000 and potential total tax liability of $180,000. RC does not yet have a buyer for her relinquished property. She must now close on replacement land that will cost $400,000. RC will be constructing a new office building for about $425,000. The land cost of $400,000 and the construction costs of $425,000 equal, or in this case, exceed the minimum reinvestment of $800,000, the net selling price of the relinquished property. RC will need to do a reverse-construction exchange as discussed above. The positive result is that **RC will have $180,000 of tax savings in her equity portfolio and not the IRS's!**

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1031 MAGIC AND *LEASES*

It is well established in tax law* that legal title does not have to pass to have a completed sale or exchange. A transfer of *equitable* ownership along with the "burdens and benefits" (the "*BB")* of ownership will constitute a competed sale or *exchange*, even if the deed is not transferred. [**Fred White*, TC Memo 1974-69; *Union Pacific R.R. Co*. (1936, CA2) 86 F2d 637, 18; *Ted Merrill* (1936) 40 TC 66. Many other cases can be cited].

LEASES: A lease which in legal jargon is a "Leasehold Estate" is a type of interest in real estate. The transfer of a lease can be the transfer of an equitable interest in real estate. For purposes of 1031, leases with at least a 30 year term (or more) to run are like-kind real estate and can be exchanged, Rag 1.103l(a)-l(c).

<u>WATCH THIS</u>: Optional renewal extensions may be added to the original lease term [IRS Revenue Ruling 78-72]. This includes unexercised options [*Century Elec. Co*. 192 F2d 155 (CA8 1951)].

EXAMPLE 1: RJ has a commercial property with a 15 year lease along with a 3 renewal options of 5 years each. The total of these terms equals 30 years to run and the exchange of this lease for other like-kind real property will qualify for a 1031 tax-free exchange.

EXAMPLE 2: JR sells his motel via 1031. For his replacement property he acquires a 77 year leasehold interest in another motel. This is a qualifying like-kind exchange [IRS Letter Ruling 8453034].

CAUTION: Less than 30 year leaseholds are <u>not</u> like-kind property and therefore will <u>not</u> qualify for 1031 tax-free treatment [*Capri, Inc.* 65 TC 162 (1975].

<u>EXCEPT</u>: Leasehold for less than 30 years can be exchanged for *leasehold* for less than 30 years. [IRS Revenue Ruling 76-301]

EXAMPLE 3: IV sells her 20 year lease for $30,000 and via a 1031 exchange acquires another 25 year lease for $35,000. IV has a total tax-free exchange.

(<u>Note</u>: Had IV purchased a fee simple in RE, she would not have had a qualifying Like-kind exchange, because her lease was less than 30 years).

CREATIVE LEASES - “SANDWICH” LEASES

A sandwich lease is double-lease or subletting arrangement where the investor leases (usually on a long term basis) the property from the owner and in turn sublets the premises to another tenant(s) for a higher rental. Of course the master lease with the owner must permit the investor to sublet the property. With sandwich leases the investor can create an excellent cash return with little or no equity investment and without the complete responsibility of an “owner”.

> EXAMPLE 4: You find a distressed and amateur landlord of a vacant SFH. You know that with effective marketing the home could easily rent for $600. You negotiate a sandwich lease where you will pay $500 per month fixed rent for a 3 year lease term with the right to sublet and an option to buy. Instead of using $1500 as a security deposit & first month’s rent, you use it to cosmetically upgrade the home so it “sparkles” when shown to prospective renters (and buyers). As a result of the upgrading, you quickly find a qualified tenant for $650 a month. Bingo! You have a positive cash flow of $150 a month or $1800 a year for at least 3 years with little equity investment and without the full responsibility of an owner. Do 10 of these and you have a positive cash flow of $1500 a month or $18,000 a year?

1031 *MAGIC* AND *DELICIOUS* “SANDWICH” LEASES

If you structure a lease with a 30 year term or more, it can qualify for a 1031 exchange. This usually works best in commercial transactions.

> EXAMPLE 5: Irene Investor (“II”) negotiates a 20 year term with a 10 year renewal option on a vacant office building in a prime location. She pays a below market rental of $50,000 annually. II finds a single high-credit sub lessee who pays $75,000 a year. II is “sandwiched” in the middle with a cash flow profit of $25,000 for the next 20 or 30 years (or more if there are escalation clauses). II has created valuable leasehold that can be sold or *exchanged* (with its 30-year term). If the $25,000 a year cash flow were discounted at a 12% yield over 30 years the present value of the discounted cash flows would be $201,380 (rounded). If II were to sell the leasehold for $201,380 the investor\buyer* would receive an attractive 12% annual yield.
>
> {*NOTE: The investor\buyer may also be doing a 1031 exchange and acquiring this qualifying 30-year term leasehold as like-kind replacement property}.
>
> Let’s assume II does sell the leasehold interest via a 1031 exchange. With the $201,000-plus cash, her 1031 reinvestment options (on the next page) are many:

⇒ She can acquire another (or even several) 30-year leases for cash flow
⇒ She can acquire SFH'S for diversification
⇒ She can acquire apartments, offices, shopping centers, triple net-lease property, etc.
⇒ She can invest in her dream home in her dream location
⇒ She can acquire any *combination* of the above via the *"1031 Money Machine".*

CREATIVE LEASES - LEASES-PURCHASE-OPTIONS

EXAMPLE 6 - Here is one from Real Estate Today***:** *For one reason or another, some sellers aren't able to transfer title to property but would still like to do an exchange. They can do that by using leases creatively.*

Austin owned a large cattle ranch and federal grazing permits for several thousand more acres of rangeland. Austin didn't want to lose the benefit of the permits, but if he transferred the property's title, that would be the result. And if he leased the property to a tenant that tenant would be entitled to the benefit of the grazing permits.

But IRS rules state that even though the title isn't transferred, a lease that has all the characteristics of a sale and includes a buyout for a nominal amount at the end is considered a sale. In addition, Section 1031 of the tax code doesn't require an actual title transfer; it's the transfer of the benefits & burdens of ownership that trigger an exchange.

So Austin entered into a front-loaded, triple-net lease. His tenant paid $3 million up front and had the option to purchase the property for $100 at the end of the term. All the benefits and burdens of ownership were transferred to the tenant so the IRS treated the transaction as a sale for tax purposes.

That qualified the transaction as an exchange under Section 1031 but at the same time let Austin be the owner of record and thus retain his grazing permits. Austin's state and federal tax saving totaled about $ 1.1 million.

COMMENT: The above is a lease-purchase that qualified as a sale\transaction because the burdens & benefits passed from Austin to the tenant\buyer. We assume that the $3 million was escrowed via a qualified intermediary and Austin timely acquired a like-kind replacement property. Another example of the *1031 Money Machine!*

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1031 *MAGIC* AND *GROUND LEASES*

WHAT IS A GROUND LEASE? A ground lease (or ground rent) is a long-term lease of land with a building & improvements (or where a building will be constructed). With ground rents there are two owners:

(1) The fee simple owner who owns the land.

(2) The leaseholder who owns the property and other improvements to the land, but must pay rent to use the land.

GROUND LEASES - SOME BENEFICIAL WAYS THEY ARE USED

LEVERAGE - Here the lessee utilizes the leasehold estate to finance the construction of buildings on the land, or as a way to refinance partially. In effect, leasing the site is similar to obtaining a loan of 100 percent of the land value.

WORKING CAPITAL - Generally, no income is generated from raw land except by way of resale proceeds. Sometimes industrial firms invite investors to buy ground leases on established locations with the aim of generating working capital from an otherwise nonproductive asset.

CASH FLOW - Some landowners prefer to lease rather than sell land to developers. For developers, this decreases the need for cash outlays in the early years of development. The landowner generates cash flow from the lease payments. (Such a ground lease may have to be subordinated to a senior loan). Other variations to ground leases to generate cash flow from land are, for example, parking lots, mobile homes parks, golf driving ranges, Christmas tree lots, drive-in-theaters, nurseries, supplies storage, etc.

AVOIDING UNFAVORABLE “DEALER STATUS” - Renting the land also may aid in protecting tax status as a Section 1231 “investor” instead of a *dealer** (who holds RE as inventory to be sold to customers in the ordinary course of business).

[*Note: In tax law “dealers” lose many tax benefits such as lower capital gain rates, using a 1031 exchange or section 453 installment sale reporting. Dealers are also subject to self-employment (social security) taxes (see section IV)].

GROUND RENTS QUALIFY FOR A 1031 EXCHANGE

Land subject to a 99 year condominium lease is like-kind property in a 1031 exchange. [*Koch*, 71, TC 54, 1978 Acq]. In fact as long as the leasehold has a term of 30 years or more (including renewal options), it is like-kind property. (See the last section on leases)

GROUND RENTS IN MARYLAND

In Maryland (and certain other parts of the country) some property owners do not own the land under the property. They instead pay a yearly ground rent to the true owner of the land - the fee simple owner. In Maryland, a ground rent lease typically runs for 99 years and is renewable forever. The yearly ground rent is set by law and is generally 6% of a par value of the land. For example, if the land is valued at $5000, the ground rent would be set at $300 a year ($5000 x .06). The homeowner, at any time, can buy the land at the par value and eliminate the paying of the ground rent. (Note: For property that you already own, you can create your own ground rents.)

THE WAY TO GENERATE A WORTHWHILE YIELD WITH GROUND RENTS IS TO BUY THEM AT A DISCOUNT

Ground rents can be suitable (and qualified) investments as replacement property in a 1031 exchange. For one thing they are not management intensive as typical rental units (such as apartments). However the return is not going to be exceptional if you are to look in states such as Maryland where the yield is only 6% at face value. The way to increase your yield is to buy the ground rent at a discount *below* the par or face value (similar to what investors do when they buy mortgages).

AS WITH OTHER TYPES OF REAL ESTATE, WITH GROUND RENTS...

- ◊ You can buy them from the fee-land owner
- ◊ You can also buy them from estates, or banks (as REO's)
- ◊ You can buy inherited ones directly from the heirs
- ◊ Sometimes they are offered in blocks as high as a 100 of them
- ◊ You want to buy stable ground rents in good neighborhoods
- ◊ There are higher grade ones where the stated yield is increased periodically
- ◊ You need to check the return on investment
- ◊ You still must do your due diligence (i.e. your "homework").

{NOTE: You can also buy the property that sits on the ground from the leasehold-owner}.

1031 MAGIC & GROUND RENTS - EXAMPLE:

THE PROBLEM SCENARIO:

LB owns a management-intensive multi-unit property in a neighborhood that probably will not get any better in the foreseeable future. The net selling price of the property is $100,000 and there is almost no basis. The resultant federal & state tax liabilities would be about $35,000.

THE SOLUTION WITH 1031 MAGIC:

LB engages a QI; settles on the relinquished property; and places the $100,000 into a 1031 escrow account. He quickly goes out, does his homework and (within 45 days) acquires 31 ground rents totaling $103,820 and resulting in a *total* tax-free exchange (the $103,820 cost exceeds the $100,000 net selling price).

THE POSITIVE RESULT:

The $103,820 cost is a discounted price that equates to an average annual yield of 12% which is not stupendous, but is much better than a bank CD. Moreover there is the following:

⇒ The ground rents are in *good to excellent neighborhoods* (including Ocean City, MD)
⇒ The ground rents are *not management* intensive
⇒ LB has substantially *diversified* his portfolio from 1 property to 31 units
⇒ LB's tax savings of $35,000 substantially increases his *after-tax yield*
⇒ With diversification, better locations and stable leases, LB has *reduced his risk*.

CONCLUSION

For those *1031 Entrepreneurs* who want to reduce tenant management, generate a decent yield and reduce risk, ground leases can be a viable alternative in a 1031 Tax-Free exchange.

Ground leases can also be sold as relinquished property in a 1031 exchange.
In addition, the property itself that sits on the ground can also be sold or purchased via the *1031 Money Machine.*

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COMBINING 1031 *MAGIC* WITH *OPTIONS*

OPTIONS TO BUY: An option-to-buy is an agreement that creates a *right* to buy a property at a future date, within a specified time and for a specified price (or a way to arrive at the option price).

The buyer\optionee will give the seller\optionor consideration for giving the buyer the right to purchase the property at the agreed upon term and price. Such consideration is generally money in the way of an upfront deposit. With a lease-purchase-option, the consideration can also be monthly amounts above the normal rent. Upfront deposits could also be advanced rents paid or even services provided.

"TO BUY OR NOT TO BUY - THAT IS THE QUESTION?"

The option is a "unilateral" (or one sided) agreement that gives the buyer the right to enter into a purchase agreement at a future time. It only binds the seller to sell, but does not bind the buyer to buy. Thus, the buyer has the "right" (or "option") to buy, or *not* to buy. If the agreement is structured properly, with all the proper contingencies, the buyer is not really committed to the property at all. The buyer could just walk away and the most the buyer could lose is all or part of their option deposit. They are not further obligated and generally nothing happens to their credit rating. (In fact with the right contingencies it is possible to still get your deposit back).

> An option is an excellent way to *control* property with *minimum cash, minimum risk*, and *high yield*. For example, a $100,000 property may normally require a $20,000 or $30,000 down payment. However, a much lower option deposit (such as a $1,000 or $2,000) can control the property for the buyer\optionee, while the risk & responsibility of the property remain with the owner (the seller\optionor). With a lease-purchase-option it is possible to control a property with no option deposit (no money down) and just offer the first 3 (or whatever) months rent in advance as the option deposit.

There are other variations beyond the scope of this book.

OPTIONS TO SELL (A MARKETING TOOL): Options can also be an effective marketing tool for the owner as well. They could turn negative cash flows into positive; turn a "typical" tenant into a *super* tenant; reduce management expense & responsibility and eventually get the property sold or *exchanged (tax-free)*.

EXAMPLE 1: Let's say you are typically renting a house out for $600 a month and paying $700 in monthly payments. You have a pre-tax negative cash flow of a $100 a month which is not that bad for one property. However if you owned 10 properties, now the negative would be an "alligator" of $1000 a month. Moreover the tenants are what I call "typical" tenants, meaning that they are not bad; they will pay the rent pretty much on time and take OK care of the property. However, they will pay you no more than market rent and while they may not do outright damage, they still will not treat the home as if it's their *own.* They "typically" will stay a year and then you wind up with a 100% vacancy, plus clean-up costs.

Now suppose you rent the home with a lease-purchase-option, where the tenant (future buyer), gives you a $1500 non-refundable option deposit as a right to buy the home in 2 years at an agreed upon price. They pay you $750 a month with $150 of this amount to be credited toward the purchase price. The tenant is also responsible for all repairs and maintenance (except major components such as the heater).

Bingo! Instead of a negative cash flow of $1200 a year, for the first year you have a *positive* cash flow of $2100 (the $1500 deposit and the additional $600 or $50 per month x 12 mos.). In the second year, you will have the additional $600 as positive cash flow, plus NO vacancies & clean-up expenses. Moreover, because the tenant will be buying the home, they will *think & act* like a homeowner and not a *typical* tenant. As a result they will also take better care of the home as if it were their own. Maintenance and repair costs are reduced. If they default on the option, you still have positive cash flow because you get to keep the deposits and rent credits. Of course you could always extend the option period for an additional option deposit (and more cash flow).

OPTIONS AND 1031 EXCHANGES

Using options either to acquire or sell real property will not interfere with a qualifying 1031 exchange, provided that the option is a *pure option* which gives you only the *right* to enter into an agreement. The option should not give any type of legal or equitable ownership. {*Boise Cascade Corp.*, TC Memo 1974-315]. That is the burdens & benefits of ownership should *not* pass. If it does then there could be constructive receipt which could disqualify the 1031 exchange. [Other cases supporting the use of options in 1031 exchanges are *Coastal Terminals, Inc.* 320 F. 2d 333 - 1963 and *Front Street Inc.* 65 TC 124 - 1975].

EXAMPLES - INTEGRATING OPTIONS WITH 1031 EXCHANGES

EXAMPLE 2: Referring to the previous example of the rental home, the $1,500 option deposit and monthly rent credits would be taxable boot. However, when the tenant\buyer exercises the option to buy the property, the remaining net sales proceeds can be converted to a 1031 exchange by escrowing the funds via the qualifying intermediary (QI). The option agreement and lease would also have to be amended with an 1031 exchange addendum prepared by the QI. (Other exchange documentation would also be prepared by the QI).

> **1031 TAX TIP**: The seller\exchangor in the above example may arguably avoid boot taxable income on the $1500 deposit and monthly rent credits by later depositing them in the exchange escrow account prior to the settlement of the relinquished property (IRS letter ruling 7952086). In the exchange documents there should be language that states that all deposits received by the investor are to be assigned to the *QI.*

OPTION MONEYS GIVEN - Similar rules hold where option deposits are paid.
It is a very frequent occurrence where the investor advances from his or her own funds option or earnest money deposits as part of an offer on the purchase of replacement property. Again, to be made part of the 1031 exchange, the deposits should be assigned to the exchange escrow account. In the exchange documents there should be language that states that all deposits paid by the investor are to be assigned to the *QI*.

> **ADVANCED PLANING TIP**: If at the time of the option, you know you are going to do a 1031 exchange upon the option's exercise, then you should engage the QI *before* receiving or paying option deposits. The positive result is that right from the beginning, all deposits will go through the QI and all exchange documentation could be set up in advance. Any trace of constructive receipt can be totally eliminated.

EXAMPLE 3: You lease\option a property (that you have previously owned) for a 2-year option term, an upfront deposit of $5,000 and an option price of $150,000. Because your tax basis is $80,000, the taxable gain would be $70,000 and your capital gain's taxes $20,000. The tenant/buyer decides to exercise their option and purchase the property from you. *Before* the closing you hire a QI which executes the proper 1031 exchange documents and escrows the net proceeds from the closing. As a 20% down payment, the above tax savings of $20,000 allows you to purchase an additional $100,000 of property over the one you sold for $150,000. This means you acquire a $250,000 property, which is in a much better location, generating more cash flow with more potential for appreciation.

> **COMMENT**: The combination of creative strategies such as lease\options and 1031 exchanges is a virtual tax-free money-making machine!

A FINAL NOTE ABOUT OPTIONS - On the selling end, options could also be effective for appeasing an impatient buyer. At least the buyer would have a right to enter into agreement and could even start using the property by leasing it. On the buying end, by postponing the closing of the relinquished property, options could also be effective for extending the 45/180 day time deadlines (see Section IV).

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1031 MAGIC AND *EASEMENTS*

HOW TO MAKE A *TAX-FREE* PROFIT AND STILL LIVE IN THE PROPERTY

WHAT IS AN EASEMENT? Under real property law, an *easement* is the right to use the land of another party for a particular purpose. An easement can be sold for cash (or other consideration) by the owner to a buyer\grantee.

The granting of an easement is considered a sale for tax purposes. The granting of an easement of air rights over property adjoining an airbase was a sale [IRS Revenue Ruling 54-575]. A perpetual easement to a portion of unimproved land granted to the state for a highway was a sale [IRS Revenue Ruling 72-255]. An easement is considered to be an interest in real property [IRS Revenue Ruling 59-121]. Therefore the granting of an easement is considered a disposition and can qualify as like-kind property in a 1031 exchange [Revenue Ruling 72-549]. This is so even if the underlying property is your home.

> OTHER RIGHTS CAN ALSO QUALIFY: The sale of perpetual water rights can be rolled over into land (or other like-kind property) in a qualifying 1031 exchange (provided the water rights are real property under local law) [IRS Revenue Ruling 55-749]. Mineral rights also qualify, provided they are real property under local law and the transfer is irrevocable [*Crichton,* 122 F. 2d 181 (CA 1941)].

THE NICE THING ABOUT SELLING AN EASEMENT RIGHT IS THAT YOU STILL GET TO KEEP THE UNDERLYING PROPERTY

When you sell an easement, you are selling off certain “rights”. You are not selling the property itself. Of course, by selling off the rights there are still certain restrictions that you must comply with. However, you still can enjoy much of the benefits of the property, including living there.

<u>EXAMPLE</u>: DF owns farm property. The property possesses significant "agricultural, wetland, aesthetic, natural habitat and conservation values" which are of great importance to the county and the state conservation foundation. They want to preserve and develop farmlands because they are important to the present and future economy of the state and its citizens. The county and foundation purchase an agricultural easement from DF for a net selling price of $165,000 which is *all* gain and would result in over $50,000 in taxes. DF is now restricted on his property in that certain non-agricultural uses are prohibited. However DF still owns the property and still may do the following:

- Live there with his family
- Use it to derive income from recreational activities such as hunting, fishing, cross-country skiing, ecological tours, etc.
- Rent, sell or exchange the property
- DF still retains all oil, gas and other mineral rights in the property.

> [NOTE: DF retains all of the above provided it does not interfere with agricultural use or development].

1031 MAGIC: DF sells the easements via a 1031 exchange and escrows the $165,000 with a QI. For like-kind replacement property, he timely acquires 2 lots for $145,000. He will cash out on the difference of $20,000 which he knows is taxable boot. DF has some loser stock that he will unload which will show a loss of about the $20,000. Therefore he totally avoids any taxable gain.

THE 1031 MONEY MACHINE RESULT FOR DG:

⇒ DF legally avoids paying over $50,000 in taxes, on what is ALL <u>cash</u> profit

⇒ He still keeps his property to which he still can earn additional income

⇒ He (and his family) still get to live in the property

⇒ Besides the present property, he now owns 2 more parcels of real estate

⇒ He does it *all* TAX-FREE!

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1031 EXCHANGES AND *FORECLOSURES*

In general, there are two scenarios where 1031 exchanges can hook up with foreclosure (or distress) situations:

1. ON THE DISPOSITION OF THE *RELINQUISHED* PROPERTY
2. ON THE ACQUISITION OF THE *REPLACEMENT* PROPERTY

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1. ON THE DISPOSITION OF THE *RELINQUISHED* PROPERTY

The tax law says that a gain (or loss) is recognized on the sale or "disposition" of a property [IRC 1001]. A regular sale of property is not the only type of "disposition" and is therefore not the only way to incur a gain. Another type of disposition that could result in a gain is the foreclosure of a property. The sales price (or *"amount realized"*) would be the amount of debt relieved. If the debt relieved exceeds the tax basis of the property, then there is a taxable gain. However unlike most normal sales, where there is cash to be received, a foreclosure disposition results in our old nemesis -*"phantom income",* which is *non*-cash income, but is still taxable (see section VIII-3).

THE PROBLEM SCENARIO:

Dan's relinquished property has a past due mortgage of $300,000 and a tax basis of $100,000. Dan's property is foreclosed on by the lender. Dan has a taxable gain of $200,000 (the $300,000 debt relieved less the basis of $100,000). It's *as if* Dan sold the property for $300,000 (but did not get cash). With a gain of $200,000 and assuming a rounded total bracket of 30%, Dan would incur a $60,000 tax bill. What really hurts is that Dan did not even receive the cash to pay the taxes. Remember, his amount realized is the debt relieved which is phantom or *non*-cash income. (Note: Any deficiency judgment Dan would have to pay would reduce the gain. Assume here there is none and the gain still remains at $200,000).

THE SOLUTION WITH 1031 MAGIC (AND A CASH INVESTOR):

Assume, through a QI, Dan does a 1031 exchange on the above disposition. He exchanges up to a great deal on a replacement property for $400,000 with a mortgage of $300,000 and $100,000 cash* down payment (ignore closing costs).

> [*NOTE: Just because someone is foreclosed on, does not mean they are "broke" or hurting for cash. Like many people in the last several years, Dan was an honest and prudent investor. However, this last economic downturn hit so sudden, so hard and so unexpected, that the best of people were hurt (many times severely so). The astronomical record number of forecloses and bankruptcies proves this. Many properties could not carry themselves. They had declined substantially in value, had substantial negative equity and prohibitive negative cash flows. This is what happen to Dan. He just had to "quit" and "stop the bleeding" to prevent a "financial death". However, just because you fall into water, does not mean that you drown. Dan is swimming to safety and is getting a great deal on the property to make up for his loses. Dan may have the $100,000 cash directly or the *source* of the cash].

Dan has many contacts and this replacement property is a great deal. Assume Dan uses a financially sound cash investor to put up the $100,000 and to co-sign on the mortgage. The investor and Dan will own the property as tenants-in-common and <u>not</u> partners (because a partnership interest is not like-kind property; see sections IV, VIII-5,6). The investor's investment of $100,000 will be a 1/4 interest in the property. Dan will have the other 3/4 interest which equates to $300,000 which is his minimum reinvestment amount to totally avoid the nasty bite of taxes on phantom income. (Remember, he disposed of his relinquished property for $300,000, the amount of the debt).

THE POSITIVE RESULT FOR DAN:

⇒ He stops his losses

⇒ He gets back into RE with a great buy

⇒ He avoids phantom income of $200,000

⇒ He avoids paying $60,000 in taxes *out of his own pocket*.

BUT WILL A FORECLOSURE DISPOSITION HOLD UP AS AN "EXCHANGE"?

It is the author's opinion that it should. Most 1031 experts agree. Skeptics are concerned that because there is no equity (or "net value") in the relinquished property, then there is no exchange. There really is no clear logic to this negative viewpoint. It's still not uncommon for real estate entrepreneurs to acquire (and sell) real estate that is 100% leveraged. As far as the tax law is concerned having equity (or net value) in property is not a requirement for ownership, even with nonrecourse mortgages [*Frank Lyon*, 435 US 561 - 1978]. Leasehold interests of 30 years or more (many with little or no equity) qualify for like-kind 1031 treatment (see section VIII-14). The most important factor is that the investor disposes or acquires the important *burdens & benefits* of ownership [see *Karl*, 71 TC 54, 1978]. If this occurs, then there can be a qualifying 1031.

Moreover, where a "qualified intermediary" is used (and should be used) the IRS would appear to have great difficulty in successfully contending that a transfer to a QI who retransfers the property to a lender in a foreclosure is not eligible for nonrecognition treatment under 1031.

ANOTHER REAL LIFE SCENARIO SAVES 7 MILLION IN TAXES!

A number of years ago we completed a 1031 rollover for a property that was disposed by something called "A deed in lieu of foreclosure" (*"DIL"*). That is, the property was deeded back to the lender in lieu of them foreclosing on the property. Again this is the same as if the property were sold. The selling price would be the amount of the debt forgiven, which is phantom income. In this situation the amount of the debt forgiven was about $100 million dollars. Via a 1031 rollover, another replacement property was acquired for about the same amount. Had a 1031 rollover <u>not</u> been done, the property owners would have owed about **7 Million in tax dollars** which would have had to come from their own funds because there was no cash proceeds as there would have been in a non-foreclosure disposition. This scenario demonstrates the PROBLEM-SOLVING POWER of *1031 magic.*

ANOTHER DISTRESSED SCENARIO WITHOUT 1031 - WHERE THE TAXES DUE <u>EXCEED</u> THE AMOUNT OF CASH AT SETTLEMENT

It can be a fairly frequent occurrence where an investor heavily remortgages their appreciated investment property and then in the near future decides to sell.
When they decide to sell they may have this false (and potentially fatal) notion,

"When I sell I will have very little cash left over after paying off the high mortgage. Therefore, I will have little or no taxable gain and I should not have to worry about the taxes".

NO WAY! This is a common misconception that has been detrimental to the financial health of many uninformed investors. Commissions and other selling expenses reduce your taxable gain. However, while the mortgage payoff will reduce your cash at settlement, the tax law does <u>not</u> permit it to reduce your taxable gain and resultant tax liability. Thus, despite a high amount of loan payoffs, you can still have a significant tax bill on the sale. In fact because of over leveraging, it is a frequent situation where the taxes due on the sale of a property exceed the cash received at settlement. This excess (known as “negative equity”) can be substantial.

THE PROBLEM SCENARIO - NEGATIVE EQUITY!:

Assume the following information on the pre and after-tax equity on a relinquished property that will incur $15,000 taxes if sold without 1031:

1. > Net Selling Price............................. $ 74,000
2. *Less:* Mortgage\loan payoffs............. - 66,000
3. = Equity before Taxes **(WITH 1031)....** = 8,000
4. *Less:* Taxes on the gain........................ <u>- 15,000</u>

5. = Equity after taxes **(WITH<u>OUT</u> 1031) = (7,000) (Negative equity)**

The investor would not have enough cash equity to pay the $15,000 taxes. They would be short by $7000. Moreover, to prevent penalties, the tax liability must be paid quarterly throughout the year (which is tough if you are short on cash!).

THE SOLUTION WITH 1031 MAGIC:

The best way to cure this unfortunate situation is "1031 magic". If the investor employs a 1031, at least they will have $8,000 of their own equity. This along with other funds (which could be a cash investor and/or creative financing) can enable the investor to acquire a replacement property for at least the net selling price of $74,000 (which would be the minimum cost necessary to totally avoid the $15,000 tax drain).

THE RESULT: The investor avoids paying $15,000 in taxes out of pocket and stays in real estate.

2. FORECLOSURES - ACQUISITION OF THE *REPLACEMENT* PROPERTY

On a more positive side, foreclosures (or distressed situations) are excellent sources for some of the best buys in real estate. Foreclose sales generally fall into three scenarios:

(1) PRE-FORECLOSURES - Here you deal directly with the owner of the property who is near or on the brink of a foreclosure action. This is a highly motivated & distressed seller that MUST SELL. Therefore, excellent buys can be had.

(2) SHERIFF SALES - Here the property has been foreclosed on and is put up for sale. You bid to buy property, frequently right on the court house steps.

(3) POST-FORECLOSURES (*REO'S*) - Here the property has not been sold at the sheriff sale, either because it was not bided on or any bids were not high enough to cover the loan balance, attorney fees & other costs. When this happens it goes back into the lender's inventory as an "REO" or "Real Estate Owned" (or an "OREO" , like the cookie). The lender still wants to unload the property and get this "cookie" off their books. Therefore excellent buys can be secured directly from the lender (who may even give you attractive financing on the property).

Excellent profits can be made in all 3 scenarios. However the degree of risk will vary depending on which one is chosen. Number (2) - Sheriff Sales - is the riskiest for several reasons:

- Undisclosed liens
- Inability to inspect the property
- Damage done by a disgruntled former owner
- Unscrupulous tactics of competitive bidders at the sheriff sale.

However, *experienced* investors still do well at sheriff sales. The key word is "*experienced*". If you are a novice, then attend sheriff sales and watch how it is done, perhaps with a mentor. There are numerous publications that could also educate you on the subject. Try major book stores.

Pre-foreclosures are the next in order as far as the degree of risk because you still have to check on liens (although you generally have more time to do it). REO'S are the least risky because the above pitfalls of Sheriff Sales are avoided. You should start with them and (even stick with them as they can be just as profitable).

{NOTE: You could subscribe to services that provide you access to current data on pre-foreclosed properties. One such service is Investors Multi-Services, Inc. (908) 505-1195]

FORECLOSURE REPLACEMENT PROPERTY IN A 1031 EXCHANGE

In a number of our exchanges, for replacement property, prudent investors snap up excellent buys (often "steals") through foreclosures. With pre-forecloses or REO'S there is usually no problem with the mechanics of the exchange. They generally occur as any other normal 1031 transaction. However there can be more difficulty at the sheriff sale. Some of the potential problems are:

(1) 45-DAY IDENTIFICATION REQUIREMENT - One of the essential requirements of a 1031 exchange is that replacement properties be identified within a time period that is no later than <u>midnight of the 45th day</u> following the settlement of the relinquished property. The 45 ID letter must clearly designate the specific legal descriptions of the properties. (See section IV). Generally with a foreclosure sale, the investor does not know exactly what specific property he or she wants or if they will successfully bid on the property. Of course it is possible that they do know and they could make the proper and timely written identification.

<u>1031 TAX TIP</u>: An exception to the above 45 ID requirement is that any replacement property closed on within the 45 days is deemed to be *automatically identified*. No written ID is necessary. It would be much better for the investor to buy the foreclosed property *within the 45*-day time frame. With foreclosure types of sales such quick closings are not only possible, but also frequently probable.

<u>ALERT</u>: Try to avoid buying foreclosures (esp. Sheriff sale's) *before* the settlement of the relinquished property. Otherwise you would have to do a *Reverse "Starker" Exchange* which would be extremely difficult (if not impossible) to accomplish in these foreclosure situations. (See section VIII-13, Reverse "Starker" Exchanges).

(2) DEPOSITS - In a standard 1031 transaction, earnest money deposits on the replacement property come directly from the exchange escrow account. The deposit is sent or wired to the Realtor, attorney or title company. However, with a sheriff sale you need cash* right on the spot (*or a cash equivalent such as a bank check). There is no waiting for wires or mail. In the ideal exchange, it is highly preferable that the exchangor not handle any money at all so there is no trace of "constructive receipt". Thus we do <u>not</u> want the exchangor to first tender the cash and then be reimbursed from the escrow account. <u>Any moneys from the escrow account directly to the exchangor could disqualify the entire exchange</u>. (See recommendations, next page).

RECOMMENDATIONS: Are listed below in order of preference:

(a) The exchangor can draw the money in advance from the exchange escrow account with the bank check payable to the sheriff (or whoever, just NOT to the exchangor). Here the exchangor may have to estimate. It is better to be over. Any excess could be directly returned back to the escrow account.

(b) Have a person *other* than the exchangor tender the cash from their account and then this other person (not the exchangor) is reimbursed out of the exchange escrow account. The other person could be a Realtor, attorney or a friend. It could even be a lineal relative. However it should *not* be the exchangor's spouse. It also should *not* be any other co-owners of the properties in the exchange.

(c) The exchangor tenders the funds from their own account and is not reimbursed from the escrow account. The deposit is included as part of the exchange, by way of a "paper" assignment of the deposit in the exchange documentation.

(3) 1031 EXCHANGE DOCUMENTS

- NOTICE OF ASSIGNMENT TO QUALIFYING INTERMEDIARY - One of the requirements of a 1031 exchange is that there be written notice of an assignment of the exchangor's rights into the replacement property agreement to the QI. This assignment is generally done by way of an addendum to the purchase agreement of the replacement property. The *1031 Exchange Addendum and Assignment* is signed by the exchangor, the *seller* and the QI. (It could also be done in letter form).With a Sheriff sale there generally is not a purchase\sale agreement. There will be a deed to the buyer usually along with some other legal documents such as assignments of bids, affidavits, etc. (each state varies). Moreover, as a seller, who is going to sign a "1031 Exchange" addendum? You probably will not get much cooperation here.

RECOMMENDATION: Fortunately there is a solution. The notice of assignment can be done in a letter form. Typically it would be a letter with the proper 1031 language. It would be prepared and signed by the QI with a "CC" to the exchangor. The letter will need the legal description of the property. Therefore the exchangor should know ahead of time which properties they will bid on. The letters of assignment can then be prepared in advance of the sales. Once this is done, the exchangor can just hand the appropriate letter to the Sheriff (or bank or attorney or all of them) at the foreclosure sale. (Additional copies should be taken). They also should be sent certified mail with a return receipt. This procedure is not as clear-cut as an addendum, but it technically should satisfy the IRS regulations requiring "*written notice of the assignment*".

- SETTLEMENT SHEET - In a typical real estate transaction (including a 1031) there are usually settlement sheets (or "HUD-1's") summarizing the numerical aspects of the transaction for both seller and buyer. When there is a 1031 exchange we instruct the title company or closing attorney to modify the settlement sheet so that it *clearly reflects* that a 1031 exchange has occurred. With a foreclosure there is generally no such document. Just the legal documents mentioned above.

TAX TIP WITH SETTLEMENT SHEETS: In an IRS audit involving real estate (including exchanges), the IRS agent generally looks to the settlement sheet as the *nuclear* document evidencing the transaction. Therefore it will benefit you to hire a title clerk to later prepare a "1031 settlement sheet" (preferably with a "HUD-1" form) from the foreclosure documentation. It should not be a significant cost (especially if you network with *friendly* title companies).

PUBLIC AUCTIONS

Another way to get below-market buys on RE is at voluntary auction sales. "Voluntary" meaning this is not a foreclosure situation. The seller, by their own choice, has decided to use a professional "auctioneer" to sell the property at a public auction. Again, we have had clients who bought (and sold) exchange property via such public auctions. The same 1031 problems that can happen with foreclosures sales can also happen at these auctions. Accordingly, you should follow the same planning recommendations.

CONCLUSION

While foreclosures (and auctions) are not perfect situations with 1031 exchanges, they certainly are doable. Moreover, combined with a 1031 exchange they can solve significant problems and lead to great buys. As always, *advanced* planning with the counsel of a *full service* QI is essential. Call 1-800-351-1031.

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COMBINING 1031 MAGIC WITH *SELLER FINANCING*

Many times to make a property more salable the seller will hold back some or all of the financing in what is known as a "seller takeback" or "purchase money mortgage". However, the part of the sales price that is toward the mortgage takeback does not qualify for the exchange, because a mortgage note is *not* like-kind property. The cash portion can qualify for section 1031 treatment.

> EXAMPLE: You are selling your investment property for a total selling price of $200,000. The buyer (either through their own funds or their own financing) will pay you $150,000 in cash and the remanding $50,000 in a note to be held by you as a seller takeback. (Closing costs are ignored).
>
> The result: The $150,000 cash portion of the total selling price qualifies for a 1031 exchange and can be placed into the 1031 exchange escrow account. This portion ($150,000) is the amount that must be reinvested in like-kind replacement property to totally defer taxes on gain under section 1031 (any lesser amount will be taxed as *"boot"*). The remaining portion of the $50,000 note from the buyer does not qualify for a 1031 exchange. However, it could be eligible for the deferral of gain through installment sale reporting under IRC 453*.
>
> {NOTE: There can be ways to structure a combination 1031 exchange and seller financing where the *entire* transaction will quality for a section 1031 tax-free exchange. These ways will be discussed shortly}.

COMMENTARY: A 1031 EXCHANGE IS A SUPERIOR WAY TO DEFER TAXES THAN AN INSTALLMENT SALE UNDER IRC 453

Where you are seeking favorable 1031 treatment, it is better to obtain from the sale as much cash as possible because the cash can be sheltered via a 1031 exchange while the installment note cannot. A 1031 exchange is a superior technique of avoiding taxes for several reasons:

- With installment sale, you still have to pay at least some taxes on the down payment and principal payments.

- A final balloon payment on the note will sock you with the remaining taxes due.
- The interest portion of the mortgage payments is usually a substantial amount and is fully taxed as ordinary income.
- With a 1031 there can be a *total* deferral of tax liabilities which could become permanent by continuing to exchange until death at which time the taxes are completely eliminated with a step-up in the property's basis to its fair market value.
- Moreover, cash flow generated from the ownership of the replacement property can be sheltered through depreciation and other operating expense deductions (see Section VIII-3).
- With a 1031 exchange, you can take out substantial tax-free cash via a refinance (see Section VI).

The bottom line: A 1031 exchange is a superior way to conserve equity and accumulate wealth.

SOME TIPS TO RECEIVE MORE CASH INSTEAD OF A NOTE:

- NEGOTIATE - Try to negotiate for more cash instead of a note. As a concession to get more cash, it may even pay to lower the price. Remember the tax savings.
- OTHER SOURCES OF CASH - Have the buyer look for other sources of cash financing such as a private investor, friend, relative or aggressive lender. Perhaps you could co-sign to assist in the financing.
- YOU AS A SOURCE OF CASH - Instead of taking back financing via a note, if you have the cash available, then you can lend the buyer the cash to buy the property. The buyer could then come to the settlement table with all cash (instead of a note). All of the cash could then be placed into the exchange escrow account and qualify for the 1031 rollover.
- SELF DIRECTED IRA AS A SOURCE OF CASH - The cash can come from a private investor's IRA. The investor's IRA would pay NO tax on the interest received. It's possible that this investor could be you! For a further discussion, refer to my *Creating Tax-Free Wealth With Self-Directed IRA's*. To order, call 1215-937-9207.

  [**RECOMMENDATION**: If you do the latter lending arrangement, you should still protect yourself with a secured note and a mortgage. Also, when seller financing is involved (with or without 1031), it is advised that you seek legal advice from a "real" *Real Estate* Attorney].

PLANNING TIPS IF YOU STILL MUST TAKE BACK SOME FINANCING AND YOU CANNOT SECURE MORE CASH:

- **TRY TO GET AS MUCH PAYMENT ON THE NOTE WITHIN THE 180-DAY EXCHANGE PERIOD --** Any principal cash payments made within the 180-day exchange period can qualify for 1031 non-recognition treatment by being placed into the exchange escrow account.

- **SELL THE NOTE WITHIN THE 180-DAY PERIOD --** You could sell the note to an investor for cash and qualify for 1031 by placing the cash into the 1031 escrow account. Again, this all must be done within the 180 day exchange period.

- **REINVEST THE BUYER'S NOTE IN REPLACEMENT PROPERTY --** Use the note received from the buyer as a downpayment on replacement property. Although this is not totally clear, many 1031 experts believe that the amount of the note would then qualify for 1031 non-recognition treatment because it has been reinvested into like-kind replacement property. The practical difficulty with this strategy is finding a seller of replacement property who would take your buyer's note as their down payment. However, with highly motivated sellers (in a buyer's market) along with the power of negotiation it is very possible (and does happen).

RECOMMENDATION: Splitting a larger note into smaller ones is also helpful. For example, splitting the $50,000 note into two $25,000 notes or four $12,500 notes would increase your options. You could use the notes as a down payment with more than one seller or use them as part of a down payment with the rest in cash. You could hold on to one note or even sell another.

ALERT: If any of the above strategies are employed, then the QI will have to go on the note as the mortgagee\lender until the end of the 180-day exchange period. Also, all mortgage payments must be escrowed through the QI during this exchange period.

- **DECIDE IF IT IS FEASIBLE TO USE A 1031 EXCHANGE --** If a significant portion of the sales price is seller-held financing, a 1031 exchange may not be warranted. Instead you could just elect installment sale reporting under IRC 453. Gain computations should be performed to assess such feasibility.

[NOTE: *Installment Sale* under IRC 453 is not the same as an *"installment land contract.* The latter involves the sale of property, where title is not passed to the buyer but held in legal escrow until the fulfillment of certain obligations on the part of the buyer. Although "installment sale" under IRC 453 can coincidentally occur with an installment land contract, the two are different. "Installment sale" is governed by federal tax law. An "installment land contract" is governed by state real estate law. An installment land contract is also referred to *as a "Contract For Deed", "Installment Purchase", "Land Contract"," or "Articles"*.].

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1031 MAGIC AND THE TAX FREE SALE OF YOUR HOME

A POWERFUL COMBINATION FOR LEGALLY AVOIDING THE TAX DRAIN

HOMEOWNERS HAVE BEEN USING THE POWER OF TAX-FREE SALES FOR YEARS -- Under prior law, homeowners had two excellent provisions to shelter taxes on the sales of their principal residences:

1. IRS SECTION 1034: (Also called, "The Section 1034 Rollover" or "the Two-year Rollover"). Under Section 1034, homeowners could defer the capital gain tax on the sale of their home by reinvesting ("rolling over") into another home of equal or greater value within two years.

2. IRS SECTION 121 - $125,000 ONE-TIME EXCLUSION: Homeowners could permanently exclude up to $125,000 of (bottom-line) gain on the sale of their home if they were age 55 or over and met certain other tests.

In certain cases the homeowner could have *combined* the $125,000 exclusion with the Section 1034 rollover to avoid additional capital gain taxes.

SECTION 121 EXCLUSIONS: Effective May 7, 1997, the above provisions are replaced with exclusions of $250,000/$500,000 of gain. Homeowners can now avoid tax on gain of up to $250,000 of capital gains if single and a $500,000 exclusion of gain if married and filing jointly. These exclusions result in the **permanent tax-free elimination of gain** and the resultant tax liabilities. Also, there is **no need to buy another replacement home** and there is **no age requirement**. Taxpayers can use the exclusions **every two years**.

***COMBINING* SECTION 1031 AND NEW SECTION 121 HOMEOWNER EXCLUSIONS = MORE TAX-FREE CASH -** Property owners can combine the power of 1031 with the above homeowner provisions in a parallel tax-free transaction.

THE PROBLEM SCENARIO:

Mary owns a duplex where she lives on one floor and rents out the other one. Initially the owner-occupied duplex was a great idea. Between the rent income and tax benefits she lives almost rent free However, Mary now has a better job and prefers no longer to be an *on-site* landlord. She now wants to improve her life style with more privacy. However, she still would like supplemental income but from a rental property that is detached from her new home. The duplex will sell for $150,000, less selling expenses of $10,000, the net selling price is $140,000. With a tax basis of $80,000, the gain would be $60,000 resulting in about $18,000 in taxes. Mary has a $40,000 mortgage that is owed on the property.

TWO PROPERTIES - For tax purposes, even though it is a single deeded property, Mary has two properties, the floor she lives in is her *principal residence* and the floor she rents out is an *investment property*. Although allocations can vary we will assume a 50-50 split between the personal-use and rental portions as follows:

	TOTAL	RESIDENCE (Section 121)	RENTAL (Section 1031)
Net selling price	$140,000	$70,000	$70,000
Less: Mortgage	- 40,000	- 20,000	- 20,000
= Net cash equity	$100,000	$50,000	$50,000 (Escrowed*)

THE SOLUTION WITH *1031 and 121 MAGIC*: Mary sells the property. She *escrows the $50,000 1031 rental portion of the net equity with a QI. The 121 residence portion (the other $50,000) does not have to be escrowed. Under section 121, there is no need for a QI as well as all of the documentation that is required for a 1031 exchange. She can just take the $250,000 single exclusion and *pocket* the $50,000 residence portion, *tax-free*. She does not have to buy another primary residence. (Although in this scenario, she does.) She can do anything she wants with the $50,000.

1031 MAGIC: With the 1031 portion (and with a substantial down payment), Mary acquires a four-plex for an excellent buy of $110,000. Out of the net cash equity of $50,000, closing costs are $6000 and she uses the remaining $44,000 as a 40% down payment. The mortgage will be for $66,000. (She could do a subsequent tax-free cash-out refi as illustrated in section VI). The property shows a monthly positive cash flow of almost $600 (This is before rent increases).

121 MAGIC: With her other $50,000 cash (121 portion and with a substantial down payment), Mary acquires a beautiful & spacious townhome for $130,000 with an attractive homeowner mortgage of $97,500 at 7%, 30 years. Of the $50,000 she will put $32,500 as a 25% down payment, $7500 for closing.

REMINDER: With the new Section 121 permanent tax-free exclusions, she does not have to buy another primary residence. However, in this scenario she wisely does.

In this move-up scenario, there will be a higher mortgage (but at a lower interest rate). Moreover most of the payment will be tax deductible interest & taxes which generate more tax savings. In Mary's case, she will also have $600 of cash flow from the 4-plex to offset her home mortgage payment.

Now assume Mary's total PITI (principal, interest, taxes & insurance) on her home is $800 most of which is tax deductible. Assuming a 30% tax bracket, the tax savings of $240 a month reduces the payment from $800 to $560 less the $600 cash flow from the triplex, it costs an **unbelievable *nothing*** with $40+ to "boot" (no pun intended!).

Monthly investment (PITI)	+ $800
Less: Tax savings	- 240
Less: Cash flow - 4plex	- 600
= Monthly cost	none
= Monthly INCOME	**+ $ 40**

THERE'S MORE - In the meantime, Mary can use the $10,000 tax-free cash (borrowed at only 7%) to pay off high-interest credit cards or loans, invest in other RE, invest in tax exempt securities, take a vacation, buy a car or whatever she wants. Moreover, the "residence" interest on the $10,000 is tax-deductible (see Section VII).

THE TREMENDOUS RESULTS FOR MARY:

⇒ She totally (& legally) avoids paying $18,000 in taxes

⇒ She has positive cash flow on her rental property

⇒ With a higher tax basis, at least a portion of the cash flow can be *tax-free* income

⇒ She has $10,000 in tax-free cash without even refinancing

⇒ She can later do a tax-free cash out refi on the 4-plex

⇒ Her net monthly cost of home ownership is NOTHING at $40 PLUS

⇒ She does it all with NONE of her own out-of-pocket money.

USE THE 1031 EXCHANGE AND 121 EXCLUSIONS FOR "MIXED-USE PROPERTY", PART OF WHICH IS USE AS A HOME, THE OTHER PART USED FOR *BUSINESS* - ANOTHER SCENARIO

For tax purposes, a "mixed-use property" is a property that is used both as a principal residence and as a business or rental property. The business portion can be an apartment, a store or a home-office. Even though the property is all on one deed and will be sold to one buyer, we have two separate properties, which are treated separately for tax purposes.

TIP: The portion of your home taken as home-office deductions now qualifies for the $250,000/$500,000 exclusions of gain for principal residences. The gain no longer has to be apportioned between the residential use and the business office use. Thus, within these exclusion amounts, the entire gain can be excluded, including the office portion. Treasury Decision 9030. The only exception that still remains is the gain attributable to depreciation claimed after May 6, 1997 is not excludable and is taxable, unless you do a 1031 exchange.

> **TAX ALERT**: If the business home office or rental space is *separate* from the dwelling unit, such as with a barn, stable, farm land, or an apartment with a separate entrance, separate kitchen and bathroom, and the business or rental use exceeds 3 years during the 5-year period ending on the date of sale, gain allocable to that space is taxable.

EXAMPLE 8: M&M, a married couple, sell their home for a net selling price of $500,000 and a basis of $100,000 resulting in a $400,000 gain. The home was owned more then 2 years and 75% of the home is a principal residence and 25% a business-use property which is *not* separate from the dwelling.

	Total Amount	Principal residence (75%)	Business portion (25%)
Net selling price	$500,000	$375,000	$125,000
Less: Cost basis	100,000	75,000	25,000
Equals: Gain	$400,000	$300,000	$100,000

Also assume that depreciation claimed on the business portion is $60,000. On a jointly filed return M&M can use the $500,000 exclusion to exempt $340,000 of the gain which is the $300,000 gain allocable to the principal residence and $40,000 of the gain allocable to the unseparated business portion which is not depreciation recapture ($100,000 less $60,000). The $60,000 depreciation recapture is taxable, unless they do a 1031 exchange per below.

> TAX TIP: Do a 1031 exchange -- A way M&M can avoid tax on the *all* depreciation recapture of $60,000 is a 1031 exchange for the business portion of the home. In doing so, M&M can buy another home used both for personal and business purposes, or just buy a separate business\rental property. To totally defer the taxes on the $60,000 deprecation recapture, the allocated cost of the business portion of the new residence must equal or exceed $125,000 which is the 25% business portion of the total net selling price of the above property. If the new replacement property is a separate business\rental property then the purchase price of this property must also equal or exceed $125,000 to totally defer the taxes on the $60,000 deprecation recapture

EXAMPLE 9: Assume the same facts as the above example, except that the 25% business portion in M&M's home is an apartment which is *separate* from the dwelling unit with a separate entrance, separate kitchen and bathroom, and the business or rental use exceeds 3 years during the 5-year period ending on the date of sale. Here the entire gain of $100,000 allocable to that space is taxable. (The $100,000 includes the $60,000 depreciation recapture.)

TAX TIP: Do a 1031 exchange as per the above.

TAX POINTER: The entire property is still sold to one buyer. Here, just the $125,000 business portion is escrowed via the qualified intermediary to complete the 1031. For the $375,000 residence portion, M&M can just cash out, tax-free. While the sale is one closing, it's two separate transactions for tax purposes.

TAX TIP -- NO 1031: On the other hand, if the home were sold at a loss, then the loss on the business portion is deductible as an ordinary loss deduction. If this is the case, then do *not* do a 1031 exchange. Instead, sell the home outright with the business portion.

OTHER SCENARIOS -- COMBINING 1031 MAGIC AND THE TAX-FREE SALES OF PRINCIPAL RESIDENCES: Besides owner-occupied duplexes, triplexes, etc., other types of mixed-use properties that could benefit from this magical combination are: Live-in hotels or motels, live-in bed & breakfasts (B&B's), farms - used for business and a residence and any other type of property where the owners use it as *both* their principal residence and a rental business-use or investment property.

UPDATE: **5-Year Wait (Instead of 2) For Exclusion of Gain on Principal Residence Originally Acquired Via a 1031 Exchange**. As a result of the *American Jobs Creation Act of 2004* (October 22, 2004), replacement property that is acquired via a 1031 exchange and subsequently converted to a principal residence must wait 5 years (instead of the usual 2 years) to be entitled to exclude up to $250,000 of gain ($500,000 if married filing jointly). (IRC 121(d) as amended by Section 840 of the act)

TAX BREAK: According to 1031 exchange expert, *Steve Venuti*, CPA of *CPA Exchange Services*, *Inc.* (1-800-351-1031), the above 5 year period begins the earlier date of the acquisition of the replacement property and not the later date of the conversion of the replacement property to a principal residence. For example, as part of an exchange, Mary M. acquires a replacement property on January 10, 2005. On January 10, 2007, she coverts the replacement property to her primary residence. Her 5-year holding period for qualifying for the exclusion of gain begins on January 10, 200**5**, not January 10, 2007. At the time of the conversion on January 10, 2007, 2 years would have elapsed and she therefore would have 3 years left to be entitled to the exclusion of gain on her principal residence. (Thanks to Steve for that excellent analysis on his part.)

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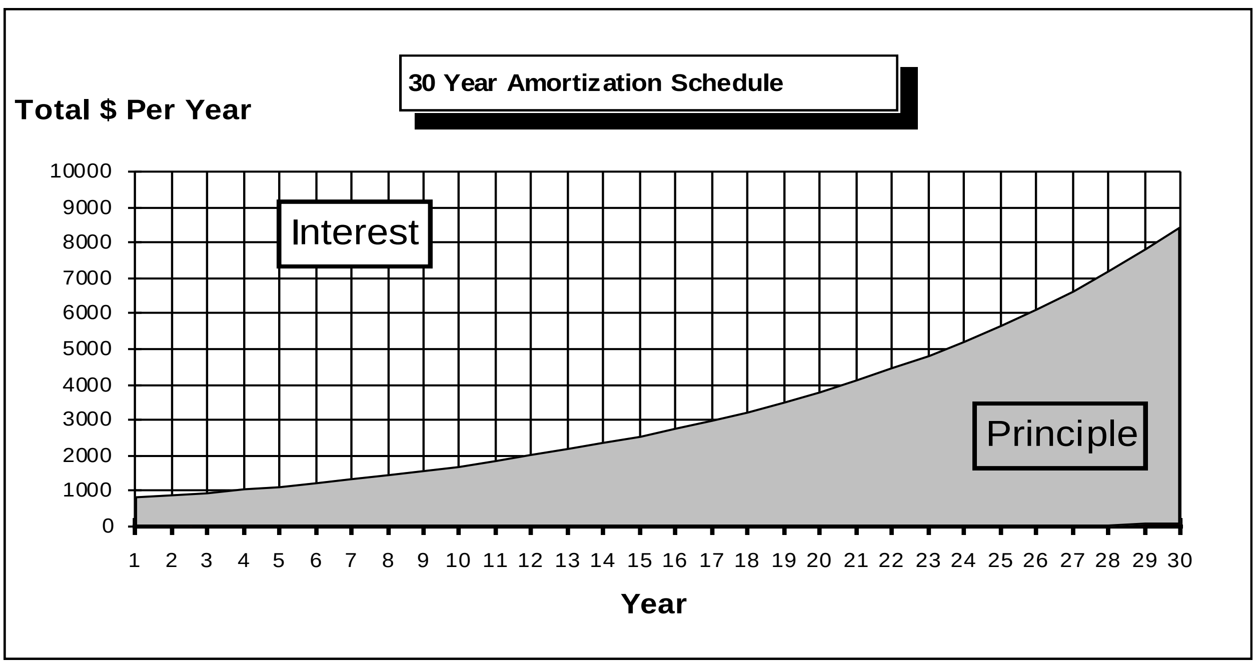
HOW TO USE 1031 TO SAVE THOUSANDS OF DOLLARS IN INTEREST

1031 *M-A-G-I-C* AND RAPID AMORTIZATION

With most mortgages, you typically will make monthly payments through what is known as *"amortization"*. Amortization is the process of paying back portions of principal in addition to the interest on the remaining mortgage. Thus your payment consists of both principal (which is really your money) and interest (which is the *cost* of the loan). The following chart illustrates the apportionment each year toward principal & interest on a mortgage-loan of $100,000 at 10% for 30 years:



{Courtesy of Robert Corl, Real Estate Educator}

As it can be seen the interest portion is heavily front loaded for much of the life of the mortgage (especially the first 15 years).

The way to reduce this significant upfront interest cost is to prepay the principal payments (known as “rapid amortization”). The interest you would save is the amount of interest that you would have had to pay with the principal payment that you have prepaid. In other words, because you paid a certain amount of principal in advance, you do not have to pay the interest portion that corresponds to the principal portion that you prepaid.

EXAMPLE 1 - INVESTING $1848.31 TO MAKE $29,744.21:

Assume the mortgage is $100,000 at 10% fixed for 30 years (360 months). If you referred to an amortization schedule or computed it on a financial calculator, for the first 3 years the principal portion of this mortgage would be $1848.31 and the corresponding interest portion would be $29,744.21. If you pay the lender the principal of $1848.31 in advance you will save the $29,744.21 in interest (over the life of the loan). You save the interest because you "jump" further down the amortization schedule 3 years and thus eliminate the first 3 years of interest ($29,744.21). Because 3 years or 36 months has been eliminated, the remaining amortization period (or life) of the mortgage is now 324 months (360 - 36 months).

INVESTMENT REAL ESTATE - *LEVERAGE - DELEVERAGE* - and MORTGAGE AMORTIZATION

"LEVERAGE" is defined as using *other* people's money or “OPM” (such as a mortgage) to finance RE with the purpose of controlling more value and deriving more profit. The general rule about leveraging is - the greater the leverage, the greater the yield and the greater the risk.

"DELEVERAGE" is the opposite of leverage. It’s using more of *your own* money to finance RE. The general rule about *de*leveraging - is the less the leverage, the less yield and the less risk.

Real estate is the undisputed SUPERSTAR of leverage because there are many ways (both conventional & unconventional) to finance the purchase of property with little or no money down. Therefore leveraging is an important tool of successful real estate investing.

Prepaying principal payments is a method of deleveraging and is therefore generally not recommended for investment RE. However there are always exceptions and deleveraging, through rapid amortization, may be beneficial in the following situations:

- The present mortgage has a high interest rate

- The investor is getting older and wants to retire with less encumbered properties
- The investor is getting older & wants to pass on to his heirs free & clear properties
- The investor is more conservative and feels more comfortable being *debt-free*
- The investor is subject to passive loss limitations. (Prepaying the mortgage will reduce interest deductions which in turn will reduce the suspended loss . The income earned will be equivalent to the interest rate on the mortgage and such income will be sheltered by the suspended losses)
- Any combination of the above.

THE MAGIC OF 1031 AND RAPID MORTGAGE AMORTIZATION

1031 magic can be combined with rapid amortization to save *both* taxes and interest It is done by using the excess cash boot in a move-up exchange to prepay the mortgage on the replacement property.

Remember taxable boot can also occur in a move-up 1031 rollover. It happens when you invest in a *higher*-priced replacement property, do not use up all of your equity in your old property, you obtain a higher (than needed) mortgage on the new property and take out the difference as cash. Because it is taken out *during* the exchange, this cash takeout (up to the total gain) is taxable ("BOOT") income

EXAMPLE 2: In section V, example 4 (page 50), there was $30,000 of taxable boot from that example of a move-up 1031. (You may want to review that example first).

4 WAYS TO PREVENT THE $30,000 BOOT FROM BEING TAXED ARE:

1. Refinance with a tax-free cashout *before* or *after* the exchange (see section VI).
2. Use the $30,000 to acquire more like-kind replacement property (see section IV).
3. Use the $30,000 as improvements to the replacement property as part of a construction exchange (see section VIII-11).

4. Use the $30,000 to prepay the mortgage on the replacement property*

*****The fourth strategy is where we combine the magic of 1031 and rapid amortization. Using excess funds to pay down the mortgage on the replacement property should be the same as investing the funds in the replacement property as part of a 1031 exchange. Although we do not have clear-cut guidance in the law, using the excess boot cash to prepay the mortgage of the replacement property should prevent the boot from being taxable. (Provided we properly structure the prepayment of the principal as per the next page).

1031 EXCHANGE RECOMMENDATIONS ON PROPER STRUCTURING:

To properly employ this strategy for the 1031 exchange, you should do the following:

1. The funds used to prepay the mortgage should <u>not</u> go directly to the exchangor

2. Such funds should remain in the 1031 exchange escrow account and be paid directly *from the escrow account to the lender*

3. The part of the mortgage that you want to prepay is to be prepaid *before* the end of the 180 day exchange period

4. The first regular monthly payment should also be paid from the escrow account (this is because prepayment on most mortgages is not allowed until after you make your first mortgage payment. Again watch the 180-day deadline)

5. The rights & obligations of the mortgage should be assigned to the QI. (Ideally this should be done in an addendum form which would call for the signatures of the exchangor, the QI and the lender. However, since most lenders won't sign, then the assignment could also be done in a letter form. The assignment would terminate upon finalizing the prepayment of principal and thus should not upset the mortgage loan).

EXAMPLE 3 - 1031 & AMORTIZATION MAGIC

Referring to the above example 2 (via example 4 of section V page 50), the mortgage on the replacement property is $90,000. Assume also the interest rate is 9% and the term 30 years, fixed. You have no need to refinance; you do not want to buy another replacement property; and you do not need to do any significant improvements to the replacement property you are acquiring. You do decide that you want to own the replacement property with the least amount of debt as possible. Thus you would rather prepay the mortgage using the $30,000 excess cash (from example 2).You send the escrow agent the first monthly payment of $724.16 so they could in turn send it to the lender. Now once the first payment is made, you can prepay the mortgage in any amount that you so desire.

<u>RECOMMENDATION</u>: When you prepay on a mortgage you should do it based on the sum of an *exact* number of scheduled advanced principal payments on the amortization schedule (as opposed to arbitrarily using a round number). You should also notify the lender in writing that you are making a prepayment and exactly which principal payments you are prepaying. You can do this by referencing the prepayments to a copy of the mortgage's amortization schedule.

You already have made the first payment via the 1031 escrow agent. In checking the amortization schedule for this $90,000 (9%, 30-year mortgage) you see that the next 230 payments equate to $30,222.36 in principal (and $136,334.44 of interest). You still have the $30,000 excess cash in escrow. You send $222.36 to the escrow agent so they will have $30,222.36 to send to the lender as an exact amount of advanced principal payments on the mortgage. You also provide the escrow agent a written notification to send to the lender (with the advanced principal payments). The QI does an exchange assignment (in letter form) on the mortgage. All of the above is completed within the 180-day exchange period

THE POSITIVE RESULT:

⇒ You legally avoid paying taxes of $9,000 (assuming a 30% bracket on $30,000)

⇒ You save an *astounding* amount of interest - *$136,334*

⇒ You only have 129 months left on your mortgage (because of the prepayment)

⇒ Now most of your mortgage payment will be your money (i.e. principal)

⇒ You move closer to your goal of *debt-free*!

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REPEATING A 1031 EXCHANGE

YOU CAN DO IT AGAIN!

You can *continue* to exchange your property. That is you can exchange the same property more than one time (Remember, *Defer, Defer, Deferr...Die!*).

HOW OFTEN CAN YOU EXCHANGE?

To answer this, we need to refer to the IRS holding requirement which is not clear and which many 1031 experts believe to be <u>at least</u> a one to two year holding period. We will assume two years because it is safer and comes from an IRS ruling (see section IV).

WHY DO YOU WANT TO EXCHANGE *AGAIN*?

Essentially for the same reasons why you wanted to exchange in the first place - . legally *zero out taxes* on any gain and accomplish such goals as *more income, more equity, diversification, less risk, less management, dream home, retirement*, etc.

> EXAMPLE: Three yeas ago, via 1031, RJ acquired as a replacement property a brand new water front home. Since acquiring it, he has rented it out and has also used it personally under the 2 week\10% rules - see section IX). RJ purchased the property at a great buy at a pre-construction price of $80,000.

RJ DOES HIS HOMEWORK - In doing so, he also knew the area was rapidly appreciating. (The home is now worth $130,000). RJ also knows that frequently a substantial portion of a property's appreciation happens in the first several years. After then it settles down to a more modest increment, perhaps at the present low inflation rate. RJ also believes in not getting greedy by trying to squeeze the last "bit of juice from the orange". You do not lose making a profit! Therefore it's time again to sell (exchange), reap his profit, move on, and repeat the *1031 Money Machine*.

RJ DOES IT AGAIN! - After selling expenses the property will sell (exchange) for a net of $120,000 (the property is owned free & clear). RJ engages a QI and escrows the $120,000 cash proceeds through them.

After again doing his homework, RJ acquires two properties via the 1031:

1. The first one is a four-plex right in his own area. The property is a below market buy at $100,000. RJ uses $20,000 from his escrow as a down payment with the seller holding $80,000 as a purchase money mortgage (terms are - 8-1/2%, 30 years, 10 year balloon, NO points or upfront loan costs). The remaining nominal closing costs are to be paid by the seller. The property throws off a *positive* cash flow of over $300 a month.

2. The second property is a new condo in Florida that RJ buys for $105,000 (including closing costs). Out of his own pocket, RJ adds the additional $5000 to the escrow account and acquires the property for the $105,000 - ALL CASH. As a result of buying all cash he settles on the condo quickly (within 45 days) and gets another excellent buy. As part of repeating the 1031 Money Machine process, RJ again rents it out and also enjoys it personally under the 2 week\10% rules (and don't forget our *tax-deductible* "Maintenance & Marketing" visits!). In two or three years RJ may make this his second home or a permanent retirement home in the nice warm climate of Florida. When he turns age 55, he can zero out again by taking the one-time exclusion on his primary home.

   <u>REMINDER</u>: Of course he can repeat the 1031 process again on either (or both) of the above properties.

THE POSITIVE RESULT FOR RJ IS THAT HE:

⇒ *Again* zeros out taxes
⇒ Has more diversification with two properties instead of one
⇒ Has positive cash flow (close to home)
⇒ Has a new dream home
⇒ Has the later option of converting the home into a second or first home
⇒ Can retire in a nice warm climate
⇒ Can repeat the process and *do it again!*

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1031 EXCHANGES AND *ASSET PROTECTION*

As you continue to exchange, avoid the tax drain, prudently reinvest the tax-free proceeds and repeat the process - your assets will grow. Therefore, with our ever increasing litigious society, protecting your RE assets should be a major concern. Increasing the limits in your liability insurance and buying umbrella policies are relatively inexpensive ways to protect yourself from law suits.

> LAND TRUSTS - A method of asset protection (or privacy) that is becoming more popular is what is known as a *"Land Trust"* or the *"Illinois Land Trust".* With the land trust, the title to the property is not held in your name, but held in the name of a "trustee". By doing this you have *privacy.* You are the *beneficiary* and as the owner of the trust's assets, you still retain control and management of the property. You still call all of the shots as when to sell, buy and (of course) *exchange* the property. The trustee, who holds the title to the property, could be a trusted friend, your attorney or an institution such as a title company. (You should choose your trustee carefully). Land trusts are allowed in most states and require the drawing up of certain legal documents that supposedly are not that complicated. As with 1031 exchanges, many attorneys are not familiar with land trusts. You should engage one that is.

My friend, John Schaub, is a national RE guru and is very knowledgeable about land trusts. One of the issues of his superb newsletter (*"Strategies and Solutions"*) was totally about land trusts. One of John's many excellent publication is titled *"Financial Privacy For Real Estate Investors"*. I recommend you invest in it as well as his newsletter and other fine publications. [Call 1-800-237-9222].

LAND TRUSTS QUALIFY FOR A 1031 EXCHANGE [IRS Revenue Ruling 92-105] - This is so provided the trust is not an entity (such as a partnership). It must be a *true* "land trust" where the trustee is a mere agent holding title to the property. The exchangor, as beneficiary, must retain the powers of control & management as explained above. Provided you do the latter, you can do the exchange with a land trust. You report the property's rent and expenses as you normally would on IRS Schedule E. You report the exchange on IRS Form 8824.

There you have it. You can have the best of both worlds - ASSET PROTECTION that is also *TAX-FREE!*

ALERT ON CHANGING ENTITIES PROXIMATE TO AN EXCHANGE

Corporations and limited partnerships are other forms of asset protection. From a *tax* point of view, it is generally not a good idea to hold investment real estate in a either a C-corporation or S-corporation. Generally, the best form of ownership for investment real estate is an LLC and in certain cases a limited partnership. Also, check your state's laws regarding these entity types.

Moreover, changing your property to a corporate (or partnership) entity at a time that is proximate to an exchange could disqualify your exchange, according to the IRS (although several tax court cases disagree, see Section IV). Nevertheless there still could be risk with the IRS.

If your relinquished property is already in a corporation and you want to sell the property via a 1031 exchange, you will have to keep the corporation in tact and use the *corporation* to acquire the replacement property. Otherwise liquidating the property out of the corporation will trigger the gain and resultant tax liabilities. With this type of corporate liquidation, not even a 1031 exchange will prevent the gain from being taxed. Again you need to keep the property in the corporation and have the corporation (not you as an individual) do the entire 1031 exchange. The corporation is <u>not</u> to be liquidated.

On the other hand, partnerships can generally be liquidated without tax consequence. With limited partnerships it all depends. Seek competent tax and legal counsel.

<u>TAX TIP</u>: For an in-depth discussion of ownership entities, refer to Sections 5 to 8 of *The Real Estate Investor's Goldmine Of Tax Strategies* (new updated second edition) by Albert Aiello.

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1031's AND *ESTATE PLANNING*

ESTATE PLANNING

As you continue to exchange, avoid the tax drain, prudently reinvest the tax-free proceeds, repeat the process -- your assets will grow and so will your estate!

The objectives of estate planning are to create and implement a plan for tax minimization and the transfer of wealth in accordance with your own *personal* wishes. As with 1031 exchanges, estate planning is not just for the wealthy. Even if you have limited means or just entering your peak earning years, a simple estate plan is essential. There can be many serious consequences if you die without an estate plan. A significant portion of money left to your heirs could be taxed instead. The estate of single taxpayers worth over $2, 000,000* (lifetime exemption) and estates of married taxpayers worth over $4,000,000* must pay federal estate taxes. The top rates are now about 50% (but scheduled to reduce).

(*The combined estate and gift tax exemption is scheduled to rise to in future years. Check with your tax advisor)

1031 AND ESTATE PLANNING CAN BE A GREAT COMBINATION FOR ESTATE PRESERVATION AND PERMANENT TAX SAVINGS

Instead of just "selling", if an investor continues to employ 1031, their equities (without the drain of taxes) will accumulate much more rapidly, especially over the path of time. The result will be a larger estate that has been preserved as a result of the conservation of equities without any lapses. By exchanging and holding the property until death the property will receive a "step up" in tax basis from the property's adjusted tax basis to its fair market value in the estate. Although the heirs will pick up the higher market value as their basis, this "step up" (which is the gain) is free from income taxes. Thus, by employing 1031 until death, investors do not just defer income taxes, but instead <u>permanently eliminate</u> them. Plus the heirs will have a much larger estate not only from the taxes saved but also from the years of compounded earnings on these taxes saved.

NOW WE HAVE A NICE PROBLEM - A LARGER ESTATE AS A RESULT OF 1031 MAGIC WHICH ALSO MEANS POSSIBLE ESTATE TAXES

If your estate includes valuable real estate (especially real estate acquired in a 1031), then your estate may be over the estate lifetime exemptions.

SOME STRATEGIES TO REDUCE ESTATE TAXES IN THIS SCENARIO:

1. GIFT THE ENTIRE PROPERTY. Besides saving on estate taxes, gifting the property may also provide the income tax advantage of shifting away any taxable income that the property is generating.

2. MAKE ANNUAL GIFTS OF PORTIONS OF THE PROPERTY. This is done by gifting undivided fractional interests in the property, where each interest does not exceed $12,000 (or $24,000) in value. This calls for special valuation methods with a qualified expert. However, there are disadvantages of outright gifts:

- You relinquish total control over what might be a valuable property.

- If the equity of the property is over the present $12,000/$24,000 annual or $2,000,000/4,000,000 lifetime exemptions, the transfer will result in gift taxes.

- The donee will get the donor's basis which is generally lower than its value.

ALERT: "Deeding the property for a $1.00", (or any other nominal sum) is considered a gift and therefore subject to these same rules. Also, the holding requirement may be violated if the exchange property is gifted at a time proximate to a 1031 exchange. See Section IV for a further discussion of the holding requirement .

TIP: With this type of creative planning always seek competent advice. Contact us for a recommendation of a superb specialist in Estate Planning.

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1031'S WITH INVOLUNTARY CONVERSIONS AVOIDING A BUNDLE OF TAXES

Under IRC 1033, an *involuntary conversion* is a disposition of all or part of a property resulting from casualty (such as fire, flood, etc.), or from government condemnation. The proceeds from the disposition will come from the insurance reimbursement for property destruction, or from compensation for the government condemnation. The gain realized will be the difference from the above proceeds and the property's adjusted basis. This provision can defer taxes on gain if certain tests are met, including acquiring replacement property. Involuntary conversions do *not* require the use of a qualified intermediary or escrow, do not have property identification requirements and have longer time deadlines to acquire replacement property. Generally, this replacement time period for investment real estate is three years, with the possibility of extensions. For more about involuntary conversions, refer to IRC 1033, Reg. 1.1033 or IRS Publication 544.

COMBINED WITH A 1031 EXCHANGE:

An involuntary conversion due to casualty (such as fire, flood, etc.) can be prudently combined with a 1031 exchange. This will occur when the insurance reimbursement for property destruction is reinvested into like-kind replacement property according to the rules of involuntary conversion under IRC 1033; and then the remaining property (after destruction) is sold to an outside buyer via the rules of a 1031 exchange. Thus, we have two tax-deferred transactions: (1) The Section 1033 involuntary conversion of the destroyed property and (2) The Section 1031 exchange of the remaining property.

<u>EXAMPLE</u>: PC owns an office building that is completely destroyed by fire. The building has a basis of $50,000. The insurance company reimburses PC $450,000 for the fire damage to the building. Thus, there is a $400,000 realized gain and potential tax liability of $120,000. Within the proper Section 1033 time period, PC reinvests the entire $450,000 into another office building in another location. *Result*: PC totally defers the taxes on the $400,000 gain, saving PC $120,000 in taxes.

All that is remaining for PC is the land, which has a $10,000 basis and is worth $150,000. Via a 1031 exchange, PC also sells the land for $150,000 and, via the exchange, acquires a rental ("cash cow") property for $160,000. *Result*: PC totally defers the taxes on the $140,000 gain, saving PC *another* $42,000 in taxes.

Total result: PC reaps a **total tax savings of $162,000 combining 1031 and 1033 magic**!

IX. TAX-FREE EXCHANGES AND VACATION HOMES

HOW TO USE THE 1031 EXCHANGE FOR YOUR DREAM HOME IN PARADISE *TAX FREE*

X. TAX-FREE EXCHANGES AND VACATION HOMES

1031 MAGIC can you help accomplish your goals - including acquiring *dream homes in dream locations*

VACATION HOMES ARE OFTEN AN IDEAL CHOICE AS REPLACEMENT PROPERTY IN A 1031 EXCHANGE

In many of our 1031 exchanges, the property owner wants to rid themselves of a management-intensive property (such as a small apartment building). To do so, they roll over their equity from the old property (tax-free) >>> into a home located in a desirable vacation area. They could be in the bitter winter of New York City and end up in that home at the beach in the *warm* climate of Florida.

On the other hand the dream home could be:

- ♦ A ski resort condo in Vermont or Aspen
- ♦ A lake front cottage in the outer banks of North Carolina
- ♦ A cabin in the Pocono Mountains of Pennsylvania
- ♦ A home or condo at the South Jersey Seashore
- ♦ A vineyard in California
- ♦ Some resort *getaway* which could eventually become a retirement haven.

The investor does all of this and combines:

- Paying little or no taxes.
- *Leverage* with little or no money down (by using their tax-free equity)
- The favorable benefits of real estate.

They rent out the dream home for a time, receive tax-write-offs and use it personally for 2 weeks each year. After a requisite time period, they have the option to convert the home, *tax-free*, to full personal use either as a second or primary home. Ultimately, they have the home of their dreams - complements of U.S. and it's all legal!

THE ABOVE BENEFITS TO THE PROPERTY OWNER ARE SUMMARIZED:

- * Legal avoidance of taxes on the sale with the new, favorable IRS guidelines on 1031 tax-free rollovers

- * Increased equity & buying power to acquire a beautiful vacation home in many resort areas where prices are lower than ever, frequently along with higher rental rates

* Less ownership headaches than year-round property
* Permitted use as a personal-vacation home for 2 weeks in the year and even longer under certain IRS guidelines (covered later)
* Depreciation and other property tax write-offs during the rental period
* Tax-free conversion to a full personal residence after a reasonable rental holding period (covered later).
* Future appreciation potential as a result of bottomed-out prices and “value generators” (covered later).

MANY RE INVESTORS DO *NOT* KNOW ABOUT THIS GEM OF AN IDEA!

All of this presents an *expansive window of opportunity* for both property owners and real estate professionals.

> **EXAMPLE 1 - REINVESTING IN A VACATION HOME TO GET RID OF MANAGEMENT HEADACHES > *TAX FREE*:** Our Real Estate owner, Ms S, has a triplex that she has owned for a number of years. However, the property is management intensive, Ms. S is not the best property manager (she should subscribe to Mr. Landlord), plus she is not getting any younger. She could sell the property for a price of $100,000, owes $ 23,000 on the property and thus has gross equity of $77,000. Commissions and other selling expenses are $7,000, leaving her with a net pre-tax equity of $70,000. She has a low tax basis of $20,000. Her taxable gain would be $73,000 ($100,000 less $7000 less $20,000). Taxes on this gain would be over $20,000.

THE DRAIN ON EQUITY WITHOUT 1031 - If she were to sell outright (without 1031), she would be permanently drained by over $20,000 in taxes, reducing her net equity down to $50,000, instead of $70,000 (a 29% drop in equity!). Moreover, $20,000 + (the amount of taxes) can buy about $67,000 *MORE* real estate as a 30% down payment ($20,000 divided by /.30 = $67,000).

"ACRES OF 1031 DIAMONDS" & ”1031 MAGIC” - Ms. S had always dreamed of owning her own vacation home but claimed she never had the money to buy one. Sometimes "Acres of Diamonds" is right in your own backyard! Her acres of diamonds is "1031 Magic" which will enable her to fulfill her dreams.

1031 BUYING POWER **-** After touring her favorite resort areas Ms. S secures an excellent buy on a home in a great location for $200,000 (double the value of her triplex). Based on her financial profile, the Realtor determines she needs 35% down including closing costs. Now, 35% of $200,000 is - bingo ! - $70,000, her net equity in the old property, but *before* taxes. (Another NO Money Down Deal!).

Without 1031, she could not have gotten the home of her dreams. She would have had only the use of the tax-drained equity of $50,000, which as a 35% down payment, would equate to a purchase price of $142,850 (instead of $200,000).

MORE EQUITY = MORE VALUE = MORE WEALTH - She would have fallen short by over $57,000 >>> an amount that could be the difference between:

- Water front or no water front
- Beach block or way back
- 2 units instead of 1 unit
- An extra bedroom(s) or no extra bedroom
- An extra bath(s) or no extra bath
- Decorative extras or no extras
- Any combination of the above extras
- Having a dream home or not having any home at all.

The above extras are what I call *"Value-Generators"* which can *further* enhance the value of her new property, her equity, and her wealth.

THE *MULTIPLE* BENEFITS FROM 1031 - Because Ms. S employed 1031 magic she has a dream home in a dream location for which she will:

* Rent out the property for a period of time and receive valuable depreciation and other property tax write-offs during the rental period.

* Have permitted use as a personal-vacation home for 2 weeks in the year and longer under certain IRS guidelines (covered later).

* Reduce the headaches of ownership caused by her old triplex.

* Can do a tax-free conversion to a first or second home after a reasonable rental holding period (covered later).

* Have future appreciation potential as a result of bottomed-out prices plus the additional *Value-Generators* (discussed above).

* All complements of U.S. It's all legal!

EXAMPLE 2 - COMBINING VACATION HOMES, 1031 MAGIC, EARLY RETIREMENT AND THE ONE-TIME EXCLUSION OF TAXABLE GAIN

THE PROBLEM SCENARIO: Jim & Mary want to rid themselves of a rental property in a declining area. In their early 50's, they would also like to permanently retire to a nice resort area.

THE SOLUTION WITH *1031 MAGIC*:

⇒ Via a QI, they roll over their rental property (tax-free) into a home located in a beautiful vacation area.
⇒ They rent out the home for 2 years and use it personally for 2 weeks each year.
⇒ After the 2 years they convert the home, TAX-FREE, to full personal use, first as a second home and then as their new primary (*dream*) home.
⇒ They sell their old primary home and take the $250,000\$500,000 tax-free exclusions, **regardless of her age (no more age 55)**.

THE RESULT: They ultimately have the home of their dreams in paradise, all *tax-free* - complements of U.S. and it's all legal!

EXAMPLE 3 - A VACATION HOME SAVES $70,000 IN TAXES AND FULFILLS ANOTHER DREAM

One of our 1031 exchanges involved the rollover of a commercial property. After commissions, 1031 intermediary fees and other selling expenses the property had a net sales price of about $1,000,000. The replacement property to be acquired via the 1031 rollover was another commercial property at a price of $750,000. The initial taxable gain was huge and while the rollover to the lower-priced property would have saved a good portion of the taxes, the property owner would have still been short by $250,000 in value or **$70,000 in taxes** (in a federal 28% tax bracket).

THE SOLUTION WITH *1031 MAGIC*:

- With 1031 tax-free rollovers, you are not limited to acquiring just one replacement property.
- Under IRS rules, you can clearly acquire up to 3 properties (and perhaps more).
- Residential rental and commercial property can be combined in one exchange
- The property owner never dreamed of a home in a vacation area.
- With the other $250,000 (cash), through a networking *Resort Realtor*, they acquired another replacement property as a great buy on a resort property

THE RESULT: When April 15th rolled around they had:

⇒ Their new commercial property
⇒ Their dream home in paradise
⇒ More tax write-offs..... and
⇒ The pain-*relief* of not having to write a $70,000 check to the IRS!

EXAMPLE 4 - A "DREAM HOME" IS NOT JUST ONE THAT IS LOCATED IN A VACATION AREA, BUT ALSO CAN BE A BEAUTIFUL HOME IN ANY DESIRABLE LOCATION WHERE YOU WILL WANT TO LIVE IN SOME DAY

THE PROBLEM SCENARIO: Mom owns an older rental condo which is showing signs of age with deferred maintenance, upkeep and increasing condo fees. Eventually she would like to move into a newer single home.

THE SOLUTION WITH *1031 MAGIC*:

⇒ Via a QI, she rolls over the condo (tax-free) into a brand new single family home which she may live in some day.

⇒ In the meantime, she rents the home to her daughter (who takes very good care of it)

⇒ And..there is no law that says she can't visit her daughter and even stay over!

THE RESULT: Mom has increased her equity position with more potential for appreciation, a better life style and she did it *"all in the family"*.

THERE CAN BE MORE FOR MOM & DAUGHTER (AND *YOU*):

- On the sale of her primary home, mom can take the $250,000\$500,000 tax-free exclusions, **regardless of her age**.

- The IRS allows Mom to give her daughter a 20% discount off of the market rent

  Note: Renting to lineal relatives is permitted provided the relative uses the home as their *principal* residence

- This strategy can be done the opposite way with children renting to parents

- This strategy can be done with other relatives and friends as well. Your own imagination is the limit!

EXAMPLE 5 - MIXING *BUSINESS & PLEASURE* > TAX-FREE

Janet, who is single, has an older rental property in suburban Philadelphia which will sell for a net sales price (after selling expenses) of $95,000. The property has a substantial gain of $60,000 which would result in a tax bill of about $18,000. She prudently engages a Qualified Intermediary (QI) and does a 1031 tax-free exchange. For her replacement property, she timely gets a good buy on a gorgeous vacation property in Avalon, NJ. The property is a duplex which costs $200,000. She will rent out one unit and use the other unit as her dream second home. Thus half of the duplex ($100,000) will be a personal (second) home and the other half ($100,000) will be a rental property which she will properly report on her taxes as such.

THE RESULT WITH *1031 MAGIC*:

⇒ She does it *tax-free* because the $100,000 rental portion of the duplex is greater than the $95,000 net sales price on the old property. (The split between personal & rental is allowed, IRS Revenue Ruling 59-229)

⇒ She therefore totally (& legally) avoids paying the $18,000 in taxes.

⇒ In effect the duplex really cost $182,000 ($200,00 less $18,000 tax savings)

⇒ She gets to *live-in & enjoy* her new investment with supplemental rent income

⇒ She acquires *favorable financing* for her "second home" (see the last page).

⇒ She gets depreciation & other rental property *tax write-offs* on the rental potion

⇒ She *also* reaps *interest & property tax deductions* on the "second home" portion

⇒ She does it all with NONE of her own money

⇒ She gets *rid of an older property* with deferred maintenance.

ANOTHER POSSIBLE TAX-FREE STRATEGY: If she were also selling her principal residence, she could use the single gain exclusion to wipe out up to $250,000 of gain.

OTHER WAYS 1031 EXCHANGES CAN BE USED IN RESORT AREAS

In a 1031 rollover, qualifying like-kind property is a very broad category of investment or business-use real estate (see section IV). Accordingly, in resort areas there is a gourmet menu to select from:

- SMALLER RESIDENTIAL - Condos, twins, singles, duplexes, side-by-sides, etc.

- LARGER RE INVESTMENTS - Hotels, motels, apartment buildings, bed & breakfasts *("B & B'S")*, trailer parks, boarding homes, etc.

- COMMERCIAL RE - Shopping centers, offices, storage facilities.

- RECREATIONAL RE - Golf courses, tennis courts, health clubs, marinas, boat slips, etc.

- BUSINESSES - Restaurants, shops, stores, etc.

- NEW CONSTRUCTION - Must be complete in 180 days (see sections VIII-11 & 12).

- BUILDING LOTS - Provided it is not acquired with the intent to sell immediately (see section IV).

- YOU CAN MIX BUSINESS AND PLEASURE - Many property owners sell *both* their home and business\investment real estate tax free via IRS Sections 121 (exclusions) and 1031 (exchange) respectively. They then relocate to a resort area and parallel their tax-free reinvestment into a combined home and business-use RE, such as a live-in motel or "B & B" (covered later in this section).

- PARTIAL OWNERSHIP INTERESTS - Even a partial co-tenancy interest in real estate qualifies as 1031 property [IRS Revenue Ruling 73-476]. For example, a property owner may want to sell their present investment property and reinvest in a 25 or 50% ownership of a resort property. Provided that the partial ownership is a tenant-in-common interest of investment real estate, and not a partnership interest, it can qualify for 1031 tax-free treatment.

- MORE THAN ONE PROPERTY - You are not limited to selling or acquiring just one property in a 1031 rollover. (See section IV).

- ANY *COMBINATION* of the above.

THE IRS GUIDELINES CONCERNING VACATION OR SECOND HOMES AS 1031 EXCHANGE PROPERTIES - One of the basic requirements to qualify for the wealth accumulation benefits of a 1031 rollover is that both the relinquished and replacement properties must be held for *business* or *investment* use (see section IV). Vacation homes can qualify for 1031 investment property. Included in the broad definition of "investment" is holding property for future appreciation [Reg. 1.1031(a)-1(b)]. However, the IRS takes the position that the owner's personal use of such property should be minimal [IRS Letter Ruling 8103117 and IRS pub 544]. Thus, the replacement home must be acquired with the intent to operate and hold it as a rental property and not as a vacation or second home.

UPDATE: Vacation homes can now qualify for a 1031 exchange but under new restricted rules - The relinquished residence must be converted into rental property for at least a 24 month holding period before the exchange and the replacement property must also be held for 24 months immediately after the exchange, or the IRS can challenge the transaction. IRS wants the home to be rented at a fair rent for 14 days or more in each of the two years before a swap. And personal use by the owner and lineal relatives* (cannot exceed the larger of 14 days or 10% of the days rented before the exchange (Rev. Proc. 2008-16). IRS will disallow exchanges where owners take minimal steps to turn their homes into rental property, such as listing the home for rent in a distant city.

(* Under IRC 267(b) "Lineal relatives" includes parents, grandparents, children, grandchildren, brothers, sisters. Also included are certain other related parties such as closely held entities (corporations, partnerships, etc.). **However it does *not* include aunts, uncles, cousins, possibly in-laws and of course close friends)

AA COMMENTARY: You can't win them all! This is a tough one for investors and owners of vacation area properties who want to take advantage of the powerful 1031 exchange. But it is my interpretation that the 24 month holding period does not pertain to year-around (non-vacation) rental and commercial properties. For these types of properties it appears that there is still not a definite time period for holding property to qualify for 1031 exchanges. With planning a much shorter holding period can be justified.

"MAINTENANCE & MARKETING" VISITS:

Under this provision, days that you spend maintaining and marketing the property do not count as personal days [IRC 280A(d)(2)(C); *Twohey*, TC MEMO 1993-547]. You need to properly document these days this with a daily diary. Keep receipts of any tools, hardware, paint supplies or other supplies that you purchase to maintain the property. If you visit your Realtor, have the Realtor document (in writing on their letterhead) that you were there to check on your property for *"maintenance & marketing"*. Thus, during the rental period, you could use the property for 2 weeks and perhaps even additional time for maintaining, marketing & managing the property.

TAX ALERT: The way IRS agents try to uncover using the property personally for more than 14 days is by looking at utility & phone bills. Disproportionate high utility bills during the time the property is not rented (such as *"off-season"*) could be evidence for excessive personal use. If there is a phone in the property, phone bills showing frequent calls to your home or business could also be evidence for excessive personal use. Moreover under tax law the burden of proof is on you, the taxpayer. You are guilty until proven innocent! So be careful and follow our recommendations.

TAX TIP*: If you stay overnight primarily for *business*, you can deduct travel to and from the property. (Travel includes not just auto, but also air & train fares, cab etc.). Record the travel (car mileage, tolls, etc.) in your diary. You should be able to deduct 50% of all meals as you are away from home overnight, IRC 162(a). A diary recording such meals should be kept. However I would not overdo this because you do not want to raise any "*red flags"* with personal use in excess of the 14 days. *{For more creative personal tax tips, refer to my publication, *The Ultimate Tax Bible For Self-Employed Entrepreneurs*. www.alaiello.com

EXAMPLE 6 - LET'S PUT ALL OF THE ABOVE TOGETHER

You get a great deal on a vacation home. You will use it 2 weeks out of the year for you and your family. You will spend an additional 3 weeks throughout the year to maintain & market the property. So now you have 5 weeks. You need your spouse and son to help you with these maintenance chores. So they come too. You will deduct travel to and from the rental home and 50% of meals overnight for *all* of you. Along with your *Resort Realtor*, you document all maintenance & marketing activities as well as travel & meals in your daily diary. You keep all receipts.

TIP: For meals less than $75.00 you do not need a receipt; but you must make entries in your daily book of the "5 W's" - *Who, What, Where, When and Why*.)

The rest of the time you will rent the property on a short term seasonal basis. You rent to your close (but "unrelated") friend, *Frank*, who signs the lease and pays the rent. There is nothing to stop the very hospitable Frank from inviting your family (including *you*) to stay over (of course, as *guests* only).

REMINDER: After the requisite rental holding period (24 months) you have the option to convert the home, *tax-free*, to full personal use as your second or first home.

RECOMMENDATIONS FOR THOSE WHO ALREADY OWN APPRECIATED VACATION HOMES – You need to follow the new rules as per the previous update.

BED & BREAKFASTS - YOU CAN MIX BUSINESS & PLEASURE

B&B's are frequently situated in vacation or prime areas. Many property owners sell both their home and business\investment real estate tax free via Sections 121 and 1031 respectively (see Section VIII-21). They then relocate to a vacation area and parallel their tax-free reinvestment into a combined home and business, such as a B&B. The same also pertains to other lodging facilities such as motels and hotels.

ACTUAL EXAMPLES OF 1031 EXCHANGES AND *B & B'S*

- John and Mary owned a small apartment building. The neighborhood was starting to decline and John & Mary wanted to try something different. They rolled over their apartment building and home for a live-in B&B in a delightful community.

⇒ John & Mary are now happier and their B&B is very successful.

- Barbara has a B&B in a community that she loves. With the tax savings along with some leverage, she rolls over her equity into a much larger B&B n the same community.

⇒ Barbara has increased both her cash flow and equity, without having to move out of the area she prefers.

- Bernice and Carol have jointly owned a successful B&B for a number of years. They now want to go their separate ways. They sell the B&B via 1031. With her respective share of the proceeds (along with leverage), Bernice acquires her own B&B in a nearby community. Carol relocates to a different state and rollovers into a larger B&B and a condo in Hilton Head.

⇒ As a result Bernice and Carol are still friends as they have fulfilled their own aspirations, thanks to 1031.

- J.M. owns a B&B and a small apartment building all on one lot. J.M. wants to sell the apartment building, but not the B&B. He wants to acquire another (and even better) B&B that is for sale right down the block. J.M. subdivides the presently owned B&B and apartment building into two separate deeds. Via a 1031 rollover, he then sells the apartment building and acquires the other B&B.

⇒ J.M. has extended his activities to what he likes best (B&B's) and has increased his cash flow conveniently in the same neighborhood - all Tax-FREE!

SPECIAL EXCHANGE ISSUES CONCERNING *B & B'S, MOTELS & HOTELS*

The 1031 rollover of B&B's, motels, and hotels is generally not straight-forward and frequently involves these special issues. In the ensuing discussion, I will refer to B&B's, motels, and hotels as "Lodging Facilities".

PERSONAL PROPERTY (OTHER THAN REAL) - By the very nature of their business, Lodging Facilities contain a substantial amount of furnishings which is personal property.

- In a 1031 exchange of real estate, personal property (such as furniture, appliances, etc.) is not like-kind property and could cause at least partial taxability.
- Moreover, the like-kind requirement for personal property is much more narrower than that for real estate.
- Personal property can also cause the recapture of ordinary income taxed at higher rates.
- Another factor concerning taxability is how much of the price of the properties is allocated to the personal property being sold and acquired.
- With the 1031 exchange of Lodging Facilities, such taxability may be avoided by exchanging *like-kind* personal property for *like-kind* personal property along with favorable price allocations. Proper documentation is also essential. (For a further discussion of this, refer to my publication, *1031 Tax-Free Exchanges Financial Analysis & Strategies*. It is targeted for tax practitioners, but may be purchased by anyone.)

MIXED BUSINESS AND PERSONAL USE - Many lodging facility owners also use part of the lodging facility as their primary home.

- Accordingly, to avoid taxes on gain, the sale of such a mixed-use property would have to be a combination 1031 exchange for the business portion and the use of the $250,000\$500,000 exclusions (IRC 121) for the personal-use portion (Rev Rul 59-229).
- This means that the business portion would have to be exchanged into another like-kind business or investment property. [But on the personal-use portion, with the $250,000\$500,000 exclusions, the taxpayer no longer has to reinvest the sales proceeds into another principal residence. They just exclude that portion of the gain.]
- The new replacement property could be another mixed-use property such as another live-in lodging facility. However, to totally defer the taxes, the business portion must equal or exceed the net selling price* of the relinquished property. (*See Section V.)

- Whether there will be any taxable income in such a combination rollover will depend on the allocations between the business and personal-use portions.

- To create a *clear* IRS trail, there should be documentation *separating* the Section 1031 and 121 portions. (Also see Section VIII-21 for a further discussion of the above).

USE AS A SECOND HOME - Using part or all of the lodging facility as a *second* home (as opposed to a primary home) could cause a problem with a 1031 exchange. Planning recommendations for second homes have been given in this section.

TYPE OF ENTITIES - Frequently, Lodging Facilities are held in entities such as Partnerships, C-Corporations or S-Corporations. If the same entity that will be selling the relinquished property will also be acquiring the replacement property, then there should be no problem with the exchange. However, where the partners or shareholders want to go there separate ways then there could be problems with the like-kind requirement. This is because partnership *interests* and stock *interests* do not qualify for the 1031 like-kind requirement. With advanced planning it is possible to structure such split-ups to qualify for a 1031 exchange. (See Section IV).

CAPITAL IMPROVEMENTS TO THE REPLACEMENT PROPERTY AS PART OF THE 1031 EXCHANGE - There are times where the replacement property will need to be improved or renovated. It is not infrequent where lodging facilities are completely refurbished to fit the style of the community. For example, for B&B's the "Victorian" style is predominant in Cape May, NJ. I have seen old, dilapidated buildings totally restored to Victorian splendor. Under special 1031 IRS guidelines, improvements can be done to the replacement property in a move-*down* exchange. ("Construction" exchanges are discussed in the Section VIII-11).

SELLER FINANCING AND 1031 EXCHANGES - Many times to make a property more salable the seller will hold back some or all of the financing in what is known as a seller takeback or purchase money mortgage. This can be especially true of lodging facilities. (For 1031 exchanges combined with seller financing, see Section VIII-19).

THREE OTHER QUESTIONS ABOUT 1031 VACATION HOMES

1. CAN I USE IMPROVEMENTS AS LIKE-KIND REPLACEMENT INTO PROPERTY I ALREADY OWN?

For example, I own two separate (vacation-area) properties - one a rental property and the other *un*improved property (such as land). I sell the rental property via the 1031 exchange as the relinquished property. The net proceeds are escrowed and within 180 days I use the funds to erect a building structure as a replacement property on my presently owned unimproved property. Does the constructed improvements (on my property) qualify as like-kind property in a 1031 exchange? *Answer*: Yes, if they are properly structured. For a further discussion, along with updates and planning strategies, see Section VIII-12.

2. DO "TIME SHARES" QUALIFY FOR A 1031 ROLLOVER?

There really is no direct authority on time shares as like-kind property. There are two types of time shares: (1) A Time-Share *Estate* which is a fee simple ownership. (2) A Time-Share *Use* which is a right to occupy by contract, such as a long-term lease. Because it is a fee simple ownership in real estate, the first type (a time-share *estate*) should qualify as like-kind property under IRC 1031(a) {provided it is held as a *rental*}. The second type (a time-share *use*) may qualify if the *actual rental use* will be for 30 years or more (see Section VIII-14).

3. IN ORDER TO OBTAIN MORE FAVORABLE RATES, I STATED ON MY MORTGAGE APPLICATION THAT THIS WILL BE MY "SECOND HOME". WILL THIS UPSET MY EXCHANGE IN ANY WAY?

I would say, probably no. It is true that one of the requirements to qualify for the wealth accumulation benefits of a 1031 rollover is that both the relinquished and replacement properties must be held for *business* or *investment* use. If you use it personally for more than the 14 days (or 10% rule), you may violate this requirement and the 1031 exchange. The fact that you say "second home" on your mortgage application should not violate this requirement. What is much more important is what you *do* as opposed to what you say. Moreover, you could always change your intent by deciding that this is not going to be a second home but a rental property. If you rent (or attempt to rent) the property, report it as a rental on your tax returns and do not exceed the personal-use criteria, then you have qualifying like-kind rental property.

XI

THE 1031 MARKETING MACHINE

1031 Exchange Marketing Strategies

The following marketing techniques can be used by Realtors, accountants, attorneys. exchange intermediaries, title companies, financial planners and other professionals.

USING THE TAX LAW AS A *MARKETING* TOOL

By giving incentives, our present tax system encourages investment. The tax law is a like a *government subsidy*. By allowing certain deductions, credits, exemptions and tax-free rollovers, the tax law compensates real estate entrepreneurs for investing in real estate by reducing their tax bill every April 15th*.

> ***GET THOSE TAX DOLLARS *NOW*!** You do not even have to wait until April 15th. On IRS form W-4, (under certain rules) you are permitted to take advantage of these incentives by increasing your withholding exemptions. By doing so, you have less taxes withheld and you receive more dollars in your paycheck (like a "government pay raise")

There are many excellent tax saving opportunities for real estate investors and homeowners. However, many of these tax gems are little known (or not known at all). How many know about the 1031 rollover? And there are others as well. Even many so called "tax advisors" know little or nothing about them..

THESE UNKNOWN TAX GEMS ARE LIKE HIDDEN TREASURES

As a professional, instead of looking at the tax law has something negative, I have found it to be a *positive, powerful* marketing tool. The opportunity to use it as a marketing tool is further enhanced by the widespread lack of knowledge. Here you have this scenario:

⇒ Few (if any) know about something;
⇒ All of a sudden you come along and mention some great tax gem;
⇒ The client is *extremely impressed*;
⇒ For the client it is like finding a *hidden treasure* (such as informing your client about something as powerful as a 1031 tax-free rollover);
⇒ Now you are a *hero* to your client.

SOME MODERN DAY MARKETING CONCEPTS

Marketing is *everything* and everything is *marketing*. It's a *philosophy,* not a department. ***"Marketing"*** is **building positive relationships**.

"Consultative Marketing" (or "Relationship Selling") -- Is where you show a *genuine concern* for *solving* problems and addressing the *needs* of the client. Consumers today want to be helped, *not* sold. The name of the game is not just taking orders, but establishing positive *relationships* because such relationships are going to lead to sales and *continuing* referrals so you can develop residual-type income. By using consultative marketing you have much less need to "close". The client ends up closing themselves.

"Positioning" -- The marketing technique of clearly placing yourself in the minds of prospects and the marketing infrastructure. Today this is not easy. Consumers are bombarded with marketing messages - as much as a 1000 a day! Winning over the customer's inundated mind is of major importance in marketing. You must *differentiate* yourself and your services with intangibles such as *quality, reliability, knowledge, service*, etc. It helps to be unique (see *Niche Marketing*, next).

"Niche Marketing" -- You segment a particular market, focus on it, *specialize* in it and serve its needs. Either the niche is unknown or too small or too complicated to be bothered with. As a result *you create your own market* and *position* yourself.

"Tax Impact Marketing" -- Is using the dynamics of tax computations to motivate clients into consummating real estate transactions. It is also known as *"Selling By the Numbers"* and is a powerful tool. A typical example would be to show a renter why it is costing them more to rent via an "Own vs. Rent Analysis". The *1031 Money Machine* (illustrated in Section II & throughout the book) is another powerful example. Real estate is an excellent product to sell by the numbers and should be done more often

The ***"Marketing Infrastructure"*** -- Includes everyone who can *influence* the decisions of your clients, such as past clients, attorneys, accountants, Realtors, title companies, banks, mortgage companies, appraisers and other key people in the financial community. You need to develop positive relationships with the marketing infrastructure by using the above marketing techniques, networking and staying in touch.

"Marketing Myopia" -- This is not a positive. The disease of not knowing what business you are in. It can even be fatal. The railroads would have been much more successful if they did not think of themselves as being just in the railroad business instead of the *transportation* business. For example, what business is the Realtor in? *"I sell property"* - Wrong! The property sells the property. The Realtor develops relationships and engineers the transactions so that the property gets to the settlement table. The Realtor is in the *real estate* business which is *all encompassing* and amongst many fields, includes 1031 exchanges.

That is, the 1031 exchange is not just a “tax topic”; it is **part of the *real estate* business**. The Realtor is also in the *people* business and the *information* business. The same holds true for other financial professionals.

“1031 Exchange Marketing” -- A computer is a complicated instrument, yet you still use it as a marketing tool. If there is a technical problem you call a computer technician. Likewise, a 1031 exchange is also a complicated instrument of the tax law. However it is also a *powerful* marketing tool. If there is a technical problem you call a “1031 technician”.

1031 exchanges are still little known vehicles of wealth accumulation with a gourmet variety of investment options. Anything that is different, not well known and beneficial draws *attention.* The 1031 Exchange is a powerful tool of all of the above marketing techniques - ***“Consultative Marketing”, “Positioning”, “Niche Marketing”*** and ***“Tax Impact Marketing”.*** It is an excellent vehicle to develop your ***“Market Infrastructure*** and to *avoid* the disease of ***“Marketing Myopia”.***

LET EVERYONE IN THE MARKETING INFRASTRUCTURE KNOW ABOUT 1031’S. USE THE 1031 AS A *MARKETING TOOL* TO INCREASE YOUR BUSINESS EVEN IF THE *ADDITIONAL* BUSINESS IS *NON*-1031 RELATED.

SPECIFIC MARKETING TECHNIQUES

You need to constantly make your clients, prospective clients and referral sources aware of the wealth accumulation of 1031 rollovers. The methods listed below can be topics unto themselves as there is a variety of literature that has been written on them. Therefore, I will only touch on them:

Direct Mail - This is considered to be one of the most cost effective methods of marketing. You can direct mail present and past clients as well as prospective clients. Some tips on direct mail marketing are:

- Do it as much as you can. It's a game of "numbers".
- The more you do, the more response you will get; the more response, the more business.
- Try not to make your mailings look like "junk mail".
- Send first class; handwritten mailers get more attention as do mailers with color. ("Color sells, black & white tells").
- Try to time the mailings so that the prospect receives it Tuesday through Thursday.
- Try larger color post cards -- they grab attention and cost less.
- Use a computer data base system.
- With direct mail you should incorporate the 1031 Marketing Scripts in Appendix C.
- Also use direct mail as a follow-up to the other methods listed, especially telephone.
- In your mailers, remember the "AIDA" principal. *AIDA* -- an opera by *Giuseppe Verdi* is also a marketing acronym:

A - "ATTENTION" **-** Get it!
I - "INTEREST" **-** Capture theirs.
D - "DESIRE" **-** Arouse theirs.
A - "ACTION" **-** Get them to act NOW !

- Direct mail is not an exact science. To be really successful at it, you make the investment, experiment and just DO IT!
- You should direct mail not only to investors but *also sources* of investors such as real estate agents, accountants, attorneys, title companies, management companies, previous clients and the other sources discussed in this section.

Advertisements - You can develop leads with ads in the real estate section of your local newspaper, homes magazines and newsletters. In addition to your name, picture, phone numbers, etc., the text could state any one or combination of the following:

"INVESTORS - IF YOU WAIT FOR LOWER CAPITAL GAIN TAXES, YOU STILL HAVE TO PAY! WHY NOT LEGALLY ZERO OUT TAXES THROUGH THE 1031 TAX-FREE ROLLOVER"?

"INVESTORS - SELL YOUR PROPERTY TAX-FREE THROUGH SECTION 1031 OF THE INTERNAL REVENUE CODE".

"INVESTORS - PYRAMID YOUR EQUITY TAX-FREE THROUGH SECTION 1031 OF THE INTERNAL REVENUE CODE".

"DO YOU WANT TO AVOID TENANT MANAGEMENT AND STILL STAY IN HIGH YIELDING REAL ESTATE? THE NEW 1031 TAX-FREE ROLLOVER MAY BE THE SOLUTION!"

"RE ENTREPRENEURS - DRAMATICALLY INCREASE YOUR PURCHASING POWER THROUGH SECTION 1031 OF THE INTERNAL REVENUE CODE".

"INVESTORS - INCREASE THE MARKETABILITY OF YOUR PROPERTY THROUGH SECTION 1031 OF THE INTERNAL REVENUE CODE".

"RE INVESTORS - EXPAND YOUR INVESTMENT OPPORTUNITIES THROUGH SECTION 1031 OF THE INTERNAL REVENUE CODE".

"INVESTORS - THE NEW IRS REGULATIONS HAVE MADE 1031 TAX-FREE ROLLOVERS BETTER THAN EVER. NOW YOU CAN SLEEP AT NIGHT WITHOUT WORRYING ABOUT THE IRS"

"THE CREATIVE USE OF 1031 TAX-FREE ROLLOVERS CAN ENABLE INVESTORS TO ACCOMPLISH GOALS CONSIDERED IMPOSSIBLE".

"ROLLOVER YOUR PRESENT INVESTMENT PROPERTY FOR ONE OR MORE BETTER PROPERTIES WITHOUT PAYING TAXES! HAVE YOU HEARD BOUT THE REVISED TAX-FREE 1031 ROLLOVERS ??"

I would end any of the above with..."Call us TODAY" (your phone no.)

Newsletters - Informative and creative newsletters are one of the best ways to generate business. I prefer that you write your own newsletters on relevant and informative topics such as 1031 rollovers as opposed to recipes in the "canned" newsletter that you purchase. If your time is limited I suggest that you use the really good articles from the subscribed newsletters and ask others to write articles for you at no charge in return for a free and brief advertisement as to who they are. Certainly there are accountants, attorneys, Realtors, mortgage companies, title companies, appraisers, property inspectors, and other professionals who will be glad to get the free promotion in return for an article. Last, but perhaps best, don't forget that you may take brief excerpts from this publication including the Marketing Scripts in Appendix C. There are computer software programs available to assist you with a newsletter. Your newsletter does not have to be fancy as long as it provides information that is practical, easy to read and not lengthy. Even a one page letter with one topic could be enough. Just GET THEIR ATTENTION!

Articles - This is another effective source of increasing business. You could write articles in local newspapers, newsletters of other professionals and real estate investor associations.

Seminars - I can tell you from vast experience one of the most powerful ways to generate business is to give seminars. You can give a mini-seminar on 1031 exchanges or incorporate it as part of a broader topic such as *Real Estate Investment Strategies*. Offer the seminar to:

- Your clients (and prospective clients)
- Local Investor or apartment owner associations (they are always looking for speakers)
- Real estate companies and Realtor associations
- Title or mortgage companies (TIP: They often sponsor such seminars)
- In-house - for staff, clients & referral sources
- Any combination of the above.

Telemarketing (Telephone) - This could include "cold calling" to prospects or even better follow-up calls on leads from direct mail or advertising. (Don't forget the art of *follow-up*). The calls should also be made to your former clients. As with the other methods, telephone technique is an art unto itself. Examples of the fine points that should be known about telephoning are: *When* to call, *how* to call, when to close, how to ask questions, when to answer a question with a question, varying the tone of your voice, questions that lead to an appointment, etc. These and other phone techniques are covered in the many publications on selling. With Telemarketing, after you have introduced yourself and qualified the prospect, I recommend using Marketing Scripts 1, 2, or 4 in Appendix C. You may want to shorten or modify these scripts for the phone. You can also hire an outside company to do Telemarketing.

Networking - Networking is **people**. *"If you want to be prosperous for a year grow grain. If you want to be prosperous for ten years grow trees. If you want to be prosperous for a lifetime grow...PEOPLE"* (Anonymous Proverb).

In a business, such as real estate, you network with the following people -- sellers, renters, buyers, investors, lenders, real estate agents, rental management companies, appraisers, title companies, mortgage brokers, investor associations, attorneys, accountants, and any other sources in this section. You attend and *network* at meetings, conventions, seminars, etc. {Recommended Reading: *Power Networking* by Donna & Sandy Vilas. Call (713) 589-1989}.

SOURCES OF LEADS

Previous Clients -- "Acres of Diamonds" can be found right in your file cabinet or data base. With past clients, I would start with direct mail and a follow-up phone call. **Stay in touch!** According to *Guerrilla Marketing* author, Jay Conrad Levinson, apathy after the sale is a big reason why we lose business. I totally agree with this. (Guerrilla Marketing, 1-800-748-6444). "Follow-up" is an excellent but underutilized marketing technique whereby you simply *continue* to keep previous clients and other contacts informed that you are always available to serve them.

Previous Contacts Other Than Clients -- In years gone by you may have had dealings with professionals such as attorneys, accountants, Realtors, appraisers, title companies, lenders, & others, but for some reason lost contact. Go back into your rolodexes, phone books, files, data base, etc. and dig up these people and start making contacts. Again, always start in your own backyard with "Acres of Diamonds". Incorporate the Marketing Scripts in Appendix C.

Expired Listings -- In the MLS, look for listings of owners that have expired. There is still an unsold property. Perhaps it has been on the market for a long time because the price is above market. Frequently, when potential sellers calculate the severe tax liability they tend to "gross-up" the price to cover the taxes. This gross-up can significantly inflate the price of the property and impair marketability by disqualifying more buyers. The use of 1031 will eliminate the need for this gross-up. This enhances marketability (and a 1031 exchange).

Newspaper Sales Ads With Real Estate Agents or FSBO'S (For sale by owners) -- For FSBO'S, you should call on the ad to see if the investment-property owner has a tax problem if they sell outright. You can then use the Marketing Scripts in Appendix C.

Newspaper "For Rent" Ads -- Property for rent may also be for sale. Perhaps one reason that it has been on the market for a long time is because the price is above market due to the taxable gain liability. The use of 1031 will eliminate the need for this gross-up and enhance marketability. Another reason may be that the owner wants out of tenant management.*

Absentee Owners - The absentee owner tax record list is another very good source for identifying new clients and customers for 1031 rollovers. Tax service providers such as TRW-REDI, DAYMAR, TRANSAMERICA, R.I. LUSK & SONS can provide detailed lists of non-resident property owners for practically any area in the country. Today we also have the internet.

Real Estate Agents - Especially those who become involved with investment properties - Look for those who act as a buyer's representative. They frequently deal with RE investors.

Attorneys & Accountants - Of all the professionals, accountants & attorneys generally have the most control over their clients and often have clients who are involved with real estate. Therefore they are an excellent source of referrals. Many accountants prepare income tax returns, do financial planning, tax planning and other services which tell them a great deal about their client's needs in the way of real estate.

Property Management Companies - These companies collect rents and do other management functions for owners of investment properties. Contact them, explain the benefits of 1031 rollovers and tell them that one of your specialties is 1031 rollovers.

Investor Groups and Apartment Owners Associations - These groups meet (generally monthly) and attend seminars on the techniques of real estate investment which include acquiring real estate, financing, management, taxation, *1031 Exchanges,* and many other related topics. Frequently they have special sessions which focus on making the group aware of the properties they have for sale. Many have their own newsletter. They can be an excellent source of 1031 and (non-1031 opportunities). They are always looking for guest speakers and contributors toward their newsletters. For a list of such associations in your area see www.MRLANDLORD.com.

"MR LANDLORD" is a superb monthly newsletter on the creative marketing & management of residential properties. I believe that is the *best* real estate newsletter in the country today. I highly recommend it.

MARKETING TIP: Give a one year's subscription to Mr. Landlord as a tax deductible gift to your investor clients. Make sure they know you gave it to them. They will be very impressed. What you could do is have Mr. Landlord send each monthly issue to you so you could mail it directly to your client along with your business stationery (of course). You may even go one step further by highlighting the main points of the monthly issue in a cover letter. When it comes time to make a referral, who do you think will pop up first in their mind? *You*, of course! www.MRLANDLORD.com.

Other Referrals - Friends, neighbors, relatives, associates, etc. These too can be a source of owners of investment real estate. If they do not own real estate, ask, *"Do you know anyone who owns investment real estate?"* **LET THE WHOLE WORLD KNOW ABOUT 1031'S!**

<u>REALTOR SALES TIP</u>: MAINTAINING REPLACEMENT PROPERTY INVENTORY

This entails having replacement properties readily available for those who have already closed via 1031 and need replacement property. [<u>Reminder</u>: The investor has cash sitting in a 1031 escrow waiting to buy replacement property. In many cases you have an *instant* cash buyer!. After the property owner has closed on the relinquished property via 1031, they are subject to the 45-day identification and 180-day closing time deadlines.] Now you have a cash (or almost cash) buyer with time deadlines! **"Cash" and "Time" are two closing catalysts**.

> **<u>TIP</u>**: **TURN A NEGATIVE INTO A POSITIVE!** Time limitations are the best thing for increasing the likelihood of consummating real estate transactions (and *your commissions)*. They eliminate "*time wasters*" and "*dilly-dallies*"!

ONE WAY TO INCREASE INCOME IS TO BECOME A PROBLEM-SOLVER

Because of the above time deadlines your role as a real estate sales professional is to help the investor solve the potential problem of these deadlines. These time limitations further increase the importance of the nuclear role of the Realtor in consummating 1031 real estate transactions. On the selling end, you will need to find a buyer for the relinquished property to start the 1031 rollover. On the buying end, you will need to have suitable replacement property inventory *readily available* so the investor can make timely identifications and acquisitions.

MAINTAIN A REFERRAL NETWORK FOR REPLACEMENT PROPERTY

To increase income, *all* Realtors {residential, commercial, investment, industrial, and resort-area Realtors} need to *network* with each other all over the country. Some ways of maintaining a national real estate network are:

- The National Roster of Realtors. This is put out annually by the National Associations of Realtors (NAR) and contains pertinent information about hundreds of networking Realtors throughout the country. To order, call 1-800-553-8878.
- Through the CCIM (Certified Commercial Investment Member). These are select commercial\investment real estate professionals throughout the country. Call 1-800-621-7027 for their mailing list.
- Through commercial\investment Realtor associations as well as state and local associations of Realtors. Private franchise-type real estate companies all have their own referral network.
- "Mr. Landlord" - see the previous page.
- Contact "FSBO's" - Tell them that you have a *ready, able and willing* buyer (the "Exchangor") who must close within the time deadlines!

<u>REALTOR MARKETING TIP</u>: You should make the public aware that you have ideal replacement properties available. Suggested scripts that you could use in your marketing literature are the following:

"We have high-yielding replacement property available for a 1031 rollover".

"Need to meet 1031 exchange deadlines? We have replacement property available. Good numbers!"

"Net lease (headache-free) property available. Ideal for a 1031 rollover".

"Resort property available, ideal for a 1031 rollover".

"New construction property can be complete within 180 days for a 1031 rollover".

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THREE MARKETING TIPS WITH VACATION HOMES:

1. Through your marketing literature, contact owners of appreciated second or vacation homes. After apprising them of the wealth accumulation benefits of 1031 exchanges, inform them that their properties will not qualify for a 1031 tax-free rollover if their home is used more than 14 days for personal use. Then recommend that they convert the home to a rental property. The latter should be done only with the advice of their tax advisor.

2. Here is a way to attract investors! Vacation homes are often an ideal choice as a replacement property (or as part of several replacement properties) in a 1031 rollover. Contact investment property owners who own appreciated non-vacation homes and want to get out of management but still need to stay in real estate. One way to do this is for them to sell their properties via 1031 and acquire a vacation home of their dreams, *tax-free*. Many property owners do not know about this gem of an idea!

3. Develop a cash flow referral network with resort-area Realtors throughout the country. Again vacation-area properties all over the country are a frequent choice for replacement property. Likewise if you are a Realtor in a resort area, develop a referral network with other Realtors throughout the country who are knowledgeable about 1031 rollovers. (See Section *IX. How To Use The 1031 Exchange For Your Dream Home In Paradise*)

LET EVERYONE IN YOUR MARKETING SPHERE-OF-INFLUENCE KNOW ABOUT 1031'S. USE THE 1031 AS A *MARKETING TOOL* TO INCREASE YOUR BUSINESS EVEN IF THE *ADDITIONAL* BUSINESS IS *NON*-1031 RELATED

1031 Exchanges - The Next Step For You To Take

HERE ARE SOME SUGGESTIONS OF WHAT *"TO DO"*

⇒ Obtain at least a general knowledge of 1031 Exchanges - seminars, this book, etc.

⇒ Become knowledgeable about investment real estate - seminars, books, etc.

⇒ Maintain the belief that real estate is a **superior** investment.

⇒ Obtain at least a general knowledge of property *Management & Marketing* via seminars, books, etc. Subscribe to *Mr. Landlord*. www.mrlandlord.com

⇒ Develop a referral network with other professionals all over the country

⇒ Network with real estate investors via the many investor associations throughout the country. For a list check www.mrlandlord.com.

⇒ Personally call-up your past clients. Inform them about the *1031 Tax-Free Rollover* and its many benefits.

⇒ Direct 1031 mail to all of the Accountants, Attorneys & Realtors in your area.

⇒ *Call* them too!

⇒ Run an ad - ***"INVESTORS - NEVER PAY TAXES AGAIN - I HAVE THE SOLUTION"*** - You will get calls.

⇒ LET THE WHOLE WORLD KNOW - Mention the 1031 Tax-Free Rollover to *everyone* you meet... *everywhere*!

APPENDIX

1031 EXCHANGE TERMINOLOGY

1. **“1031 EXCHANGE”(or “ROLLOVER”)** - A legal IRS provision that allows a property owner to avoid taxes on the sale of their investment/business real estate by acquiring another like-kind investment/business property within certain IRS requirements and time limits.

2. **TAXPAYER** - The investment\business property owner who wants to do a 1031 Exchange. (Also called “Exchanger”, “Exchangor”, “Investor”, “Entrepreneur”).

3. **BUYER** - The person with cash (or the ability to get cash) who wants to acquire the taxpayer’s property. (The buyer does not own property to exchange, which is the usual case).

4. SELLER - Another person who owns the replacement property that the taxpayer wants to acquire via the 1031 rollover.

5. “RELINQUISHED PROPERTY” - The existing property owned by the investor* that he or she wants to ‘sell’ via 1031. (Note: You are *not* limited to just one *relinquished* property in a 1031 transaction)

6. “REPLACEMENT PROPERTY” - The new property that this investor* wants to acquire via the 1031 rollover. (You are *not* limited to just one *replacement* property)

7. “DEFERRED EXCHANGE” - Two closings where there will be a *delay* between the first closing of the relinquished property and the subsequent closing of the replacement property. This time span cannot exceed 180 days. (Also referred to as a “Delayed” or *“Starker”* exchange).

8. “SIMULTANEOUS EXCHANGE” - Also, two closings which happen at or about the same time and frequently at the same place of closing.

9. MOVE-*UP* 1031 EXCHANGE - An exchange (delayed or simultaneous) where the investor exchanges *up* to a replacement property whose cost is *equal to or greater* than the net selling price of the relinquished property.

10. MOVE-*DOWN* 1031 EXCHANGE - An exchange (delayed or simultaneous) where the investor exchanges *down* to a replacement property whose cost is *less* than the net selling price of the relinquished property. The down-difference will cause taxable boot.

11. 1031 SAFE HARBOR REGULATIONS - A comprehensive set of guidelines that property owners must follow to have a qualifying exchange under 1031.
(The 1991 IRS Regulations which really opened the doors for 1031’s).

12. **<u>“SAFE HARBOR”</u>** - In tax law is a provision where the IRS says that if you stay within the guidelines of our “safe harbor” we will not attack you. Under the 1031 regulations two safe harbors are using a *Qualified Intermediary* and a *Qualified Escrow Agent.* Safe harbors give important “peace of mind” to IRS sensitive taxpayers and are really one of the big highlights of the IRS 1031 regulations.

13. “<u>QUALIFIED INTERMEDIARY” (QI)</u> - Is a safe harbor in the IRS regulations
which acts as a middleman creating the “exchange” with the proper documentation. To be in accord with the IRS, ALL exchanges require a QI.

14. “<u>QUALIFIED ESCROW” AGENT</u> - Is a safe harbor in the IRS regulations and holds the net sales proceeds from the closing of relinquished property in a delayed exchange. Such proceeds are used for the purchase of like-kind replacement property.

<u>NOTE</u>: “ESCROW” and “INTERMEDIARY” are <u>two separate safe harbors</u>. Both functions can be down by two separate companies or by one company.

15. **<u>“LIKE KIND” PROPERTY</u>** - One of the requirements for a 1031 exchange. For real estate it is broad and diversified. 1031 exchanges apply to a diversity of small, large, residential, commercial, industrial, rural, resort-area or any combination of such investment properties. For example, raw land can be rolled over into income producing rental property or vice versa.

16. **<u>“HOLDING” / “QUALIFIED-USE” REQUIREMENT</u>** - One of the requirements for a 1031 exchange. Both the relinquished and replacement properties must be *held* for *business or investment* use for a period of at least one to two years and during this period the properties must not be held for resale or personal use.

17. **<u>TIME DEADLINES</u> -** TWO SETS OF TIME LIMITATIONS:

(1) <u>45 days</u> to identify replacement property

(2) <u>180 days</u> to close on identified replacement property.

Both run *parallel* from the *closing date* of the relinquished property; both <u>must be met</u> for a qualifying 1031; there are <u>NO statutory extensions</u> to these deadlines.

18. **<u>“BOOT”</u>** = Any taxable income in a 1031 exchange. You can have in one transaction a part 1031 tax-free rollover and a part taxable sale

[Note: For a further discussion of the above, see Sections IV and V].

<u>MAKE-UP OF THE TAX LAW - SOURCES</u>

1. INTERNAL REVENUE CODE (IRC or the "CODE") - The "code" is the law as enacted by congress.

2. REGULATIONS ("REGS") -- These are enacted by the Department of the Treasury. They further explain and interpret the code (often with excellent examples). Legislative regulations have the "force & effect" of law, provided they are not inconsistent with law.

3. RULINGS - - These further explain the code, regulations and court decisions. They are pronouncements put out by the IRS. They do <u>no</u>t have the force or effect of law. The IRS cannot make laws. Therefore they are not law. They are the IRS' view point on a particular area of law based on a particular set of facts & circumstances. Many rulings are favorable to the taxpayer and they can be useful. There are two types of rulings:

(1) REVENUE RULINGS (RR's) - These give guidance to all taxpayers based on a set of facts & circumstances.

(2) PRIVATE LETTER RULINGS (PLR's) - These are addressed only to the one individual taxpayer who requested the ruling on a particular area of law. (If the ruling is favorable - OK. However it can be later revoked or if not favorable - good-bye!).

4. CASE LAW (COURT DECISIONS) -- Taxpayers who disagree with the code, REGS or rulings can go to court. The most common type of court for hearing tax issues is the US Tax Court. (There are other courts and appeals can be made to higher courts all the way up to the US Supreme Court). A favorable decision depends substantially on how close the facts & circumstances are to the taxpayer's situation; whether the IRS acquiesced to the court decision; and what district the case was decided in.

ABBREVIATIONS:

E.G. – Example
I.E. - That is
QI - Qualified Intermediary
AT - Exchange Accommodation Titleholder
SFH - Single Family House
1031 - 1031 Exchange or Rollover
IRC - Internal Revenue Code
PLR - IRS Private Letter Rulings
REG or REGS - IRS Regulations
TC - Tax Court
TP - Taxpayer

Topical Index By Page No. In Text

{Note: The appendix as a reference is abbreviated "App". For example, Appendix A would be "AppA". Behind this index there is a separate index for tax cases}

Index - Tax Cases: (The issue of fact or law is in a bold letter after the case, then noted below)

ISSUE OF FACT OR LAW FOR ABOVE CASES

(a) Reverse "Starker exchange.
(b) Dealer vs. investor - intent to sell quickly.
(c) Your own property qualifying for 1031.
(d) Changing forms of ownership proximate to the time of an exchange.
(e) Options can be combined with exchanges.
(f) Leasehold interests of less than 30 years do not qualify for 1031.
(g) Mineral rights can qualify for a 1031 exchange.
(h) "Liquidation of Investment Theory" - defense against dealer status.
(i) Taking out tax-free cash via refinancing before an exchange.
(j) Foreclosure dispositions qualifying for an exchange.
(k) Equitable ownership via the burdens & benefits of ownership.
(l) *Twohey*, Maintenance visits for bypassing vacation homes rules.
(m) Clearly *separate* the "dealer" property from the "investor" property.
