1031 Tax Deferred Exchanges

"An Overview of Several Requirements for Tax Deferral"

Compliments of

KEMP TITLE AGENCY

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INCORPORATED

A National IRC §1031 "Qualified Intermediary"

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WHAT IS IRC SECTION 1031?

Section 1031 of the Internal Revenue Code allows an owner of investment property to exchange property and defer paying federal and state capital gain taxes (15% or 20% Federal, 25% depreciation recapture and applicable state taxes) if they purchase a "like-kind" property following the rules and regulations of the Internal Revenue Code. This allows investors to use all of the sale proceeds to leverage into more valuable real estate, increase cash flow, diversify into other properties, reduce management or consolidate holdings.

WHAT IS "LIKE-KIND" PROPERTY?

There is some confusion regarding what type of property qualifies for a §1031 tax deferred exchange. The Internal Revenue Code Section 1031 states that "no gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind which is to be held either for productive use in a trade or business or for investment." "Like-kind" property can include, but is not limited to, any of the following, provided it is held for investment:

- Single Family Rental
- Duplex
- Apartment
- Commercial Property
- Raw Land

For example, raw land can be exchanged for a single family rental, or apartments or a commercial building. Properties can be exchanged anywhere within the United States.

DOES AN EXCHANGE NEED TO BE SIMULTANEOUS?

No, contrary to what some property owners envision, a §1031 tax deferred exchange is rarely a two-party swap. Most exchanges are delayed exchanges, whereby the Exchanger has 180 days between the sale of the relinquished property and the closing of the replacement property. They must identify the potential replacement property (or properties) within 45 calendar days from closing on the relinquished property.

WHEN IS A §1031 EXCHANGE APPLICABLE?

It is applicable whenever a property owner intends to SELL any property that is not their primary residence (and falls under the definition of "like-kind") and plans to BUY another "like-kind" property within 180 calendar days following the closing of the relinquished property.

Paramount to any exchange is a competent and experienced Qualified Intermediary. Asset Preservation is the entity which structures, guides and documents the exchange

Five Reasons To Exchange

"Investors can Meet Many Objectives under IRC §1031"

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Section 1031 tax deferred exchanges continue to increase in popularity as more investors nationwide discover the wide range of investment objectives that can be easily met through exchanging.

I. PRESERVATION OF EQUITY

A properly structured exchange provides real estate investors with the opportunity to defer 100% of both Federal and State capital gain taxes. This essentially equals an interest-free, no-term loan on taxes due until the property is sold for cash! Often the capital gain taxes are deferred indefinitely because many investors continue to exchange from one property to the next, dramatically increasing the value of their real estate investments with each exchange!

II. LEVERAGE

Many investors exchange from a property where they have a high equity position, or one that is "free and clear", into a much more valuable property. A larger property produces more cash flow and provides greater depreciation benefits, which therefore increase the investors' return on their investment.

III. DIVERSIFICATION

Exchangers have a number of opportunities for diversification through exchanges. One option is to diversify into another geographic region, such as exchanging out of one apartment building in Denver, Colorado, for two additional apartments – one in Los Angeles, California, and the other in Dallas, Texas. Another diversification alternative is acquiring a different property type, such as exchanging from several residential units to a small retail strip center.

IV. MANAGEMENT RELIEF

Some investors accumulate several single family rentals over the years. The ongoing maintenance and management of what can be a far-reaching group of properties can be lessened by exchanging these properties for one property better suited to on-site maintenance and management. Exchanging into a single apartment complex with a resident manager is a good example of this strategy.

V. ESTATE PLANNING

Sometimes a number of family members inherit one large property and disagree about what they want to do with it. Some want to continue holding the investment and some desire to sell it immediately for cash. By exchanging from one large property into several smaller properties, an investor can designate that, after their death, each heir will receive a different property, which they can either hold or sell.

Call the knowledgeable exchange professionals at **Asset Preservation** for a complimentary consultation regarding your specific investment objectives.

A 92 Year-Old Solution for Real Estate Investors Facing Higher Taxes in 2013

"1031 Exchanges Offer Full Deferral of the New 3.8% Medicare Surtax and 20% Capital Gain Tax"

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The familiar adage, *"It's not how much you make, but how much you keep"* rings truer than ever for real estate investors in 2013. Not only have capital gain taxes increased significantly for high earners, but many investors below the top tax bracket face an additional 3.8% surtax on passive investment income like capital gains. Fortunately, IRC Section 1031, a provision which has been in the tax code since 1921, provides critically needed tax relief.

Under the American Taxpayer Relief Act of 2012, the top capital gain tax rate has been permanently increased to 20% (up from 15%) for single filers with incomes above $400,000 and married couples filing jointly with incomes exceeding $450,000. In addition, the new IRC Section 1411 3.8% Medicare surtax on net investment income, which includes capital gains, results in an overall rate for higher-income taxpayers of 23.8% -- a staggering 58% increase from 2012 tax rates!

Four Steps Involved in Determining Capital Gain Taxation

Absent the tax deferral benefits of a 1031 exchange, below is a summary of the four ways investors will be taxed on the sale of an investment property:

1. ***Depreciation Recapture:*** Taxpayers will be taxed at a rate of 25% on all depreciation recapture.

2. ***Federal Capital Gain Taxes:*** Investors owe Federal capital gain taxes on the remaining economic gain depending upon their taxable income. Since a new higher capital gain tax rate of 20% has been added to the tax code, investors exceeding the $400,000 taxable income threshold for single filers and married couples filing jointly with over $450,000 in taxable income will be subject to the new higher tax rate. The previous Federal capital gain tax rate of 15% remains for investors below these threshold income amounts.

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

4. ***State Taxes:*** Taxpayers must also take into account the applicable state tax, if any, to determine their total tax owed. Some states have no state taxes at all, while other states, like California, have a 13.3% top tax rate.

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Snapshot of 2013 Federal Capital Gain Tax Rates

Single Taxpayer	Married Filing Jointly	Capital Gain Tax Rate	Section 1411 Medicare Surtax*	Combined Tax Rate
$0 - $36,250	$0 - $72,500	0%	0%	**0%**
$36,250 - $200,000	$72,500 - $250,000	15%	0%	**15%**
$200,000 - $400,000	$250,000 - $450,000	15%	3.8%	**18.8%**
$400,001+	$450,001+	20%	3.8%	**23.8%**

* The 3.8% Medicare surtax only applies to "net investment income" as defined in IRC Section 1411.

1031 Exchanges Help Investors Defer the New 3.8% Medicare Surtax

Under recently proposed regulations, REG-130507-11, taxpayers have received proposed guidance from the IRS that notes: *"to the extent gain from a like-kind exchange is not recognized for income tax purposes under Section 1031, it is not recognized for purposes of determining net investment income under Section 1411."* [§1.1411-5(C)(i)(2)(ii)]. Although these regulations are not yet finalized, taxpayers may rely on the proposed regulations to be in compliance with Section 1411 until the effective date of the final regulations.

1031 Tax Deferred Exchanges

Despite these new tax increases, one aspect of the tax code provides real estate investors with a huge tax advantage. Section 1031 allows property owners holding property for investment purposes to defer taxes that would otherwise be recognized upon the sale of investment property. Savvy investors use 1031 exchanges to redeploy their investment capital into better performing investment properties. An exchange provides a fantastic opportunity for investment property owners to defer all capital gain taxes that would otherwise be owed.

A SALE VS. AN EXCHANGE

"ANALYZE THE BENEFITS BEFORE SELLING"

The benefits of IRC Section 1031 exchanges can be tremendous! Investors are often able to defer thousands of dollars in capital gain taxes, both at federal and state levels. If the requirements of a valid §1031 exchange are met, capital gain recognition will be deferred until the taxpayer chooses to recognize it. This essentially results in a long-term, interest-free loan from the IRS.

AN EXAMPLE

An investment property owner sells a rental property for $400,000. The owner originally purchased the property for $200,000. There is $200,000 of debt and the property has been fully depreciated. The capital gain is approximately $350,000 (assuming 75% of the property is depreciable). If the investor does not do an exchange, federal capital gain taxes would be:

$150,000 (depreciation recapture) x 25% =	$37,500
$200,000 (capital gain balance) x 15% =	$30,000
$350,000 Capital Gain Taxes Owed	$67,500

The state taxes owed (where applicable) would need to be added to the federal taxes due. Assuming the property owner sold in California, the following additional taxes would need to be paid:

State level (CA) 9.3%, $350,000 x 9.3% =	$32,550
Total Capital Gain Taxes (Fed. & State)	$100,050

The next comparison analyzes the value of the new property that could be acquired in a sale versus an exchange. The comparison assumes an investor makes a 25% down payment and finances 75% of the property (75% loan-to-value ratio).

SALE VS. AN EXCHANGE

	SALE	EXCHANGE
Equity	$200, 000	$200, 000
Capital Gain Tax	$100, 050	$0
Cash to Reinvest	$99, 950	$200, 000
ASSUMING A 75% LOAN-TO-VALUE		
New Property	$399, 800	$800, 000

This example illustrates that the real power of a tax deferred exchange is not just the tax savings – it is the increase in purchasing power generated by this tax savings!

ADVANTAGES OF AN EXCHANGE

1. Preservation of equity

2. Maximize return on investment

3. Increased cash flow from larger properties

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PROS AND CONS OF SELLING VS. EXCHANGING:

"CONSIDER THESE ISSUES BEFORE CLOSING ON PROPERTY HELD FOR INVESTMENT"

Assume a real estate investor has held an investment property for many years and will have $500,000 in net proceeds after closing. Also assume this property has $500,000 of capital gain and $200,000 of this gain is due to depreciation recapture. As you can see in the comparison below, the investor who exchanges can obtain considerably higher investment returns from deferring the payment of capital gain taxes. The current low rates for financing provide a unique opportunity for investors to lock-in excellent loan terms. Investors should explore the possibility of exchanging before closing on the sale of investment property.

	SALE (CASH OUT)	**1031 EXCHANGE (REINVEST)**
Capital Gain Taxes Owed	$95,000 *	$0 (no taxes owed in the current tax year)
Net Income to Invest	$405,000 (proceeds less taxes owed) 1–5% possible cash flow (assume 3%)	$500,000 (entire amount of proceeds received) Many real estate investments provide 6-10% cash flow (assume 8%)
Possible Income	Bank CD, Bond Fund, Money Market Assuming a 3%** return on $405,000 $12,150/annual income $1,012.monthly income	Residential Rental, Commercial, Agricultural Land, etc. Assuming a 8% return on $500,000 $40,000/annual income $3,333/monthly income
Preferential Tax Treatment	Income is not tax favored if earnings are in a non tax-qualified account May be fully taxable	Income generated is tax favored Income can be partially sheltered with write-offs Depreciation tax benefits are also available
Liquidity	Very liquid if 100% cash	Real estate is generally not very liquid
Diversification	Yes	Yes, but must reinvest in real property May diversify by asset class and/or geography
Time Restrictions	None	Yes, 45 days to identify replacement property Maximum of 180 days to close on replacement property
Replacement Asset Basis	Basis equals purchase price	Only partial basis for new depreciation Basis equals purchase price minus deferred gain

FOOTNOTES:

* Depreciation Recapture: $200,000 x 25% = $50,000; Remaining Federal Capital Gain: $300,000 x 15% = $45,000;
Total Capital Gain Taxes = $95,000; After-Tax Proceeds Available: $500,000 - $95,000 = $405,000

** Today's inordinately low rates of return for money market accounts, bank CDs and other liquid investments tilts the consideration in favor of exchanging.

This example is for education and illustrative purposes only and is not meant to provide the details for any specific portfolio or rates of return. Accordingly, you should review the details of your specific transaction with your own legal or tax advisor.

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"Understanding Common Exchange Terminology"

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To many real estate investors, the "buzz words" often used to describe different aspects of a tax deferred exchange can be confusing. For example, doesn't something with two 'downlegs' and three 'uplegs' sound a lot more like a lopsided creature than an exchange transaction? Reflected below are brief descriptions of commonly used exchange terminology:

ACTUAL RECEIPT: Physical possession of proceeds.

BOOT: "Non like-kind" property received; "Boot" is taxable to the extent there is a capital gain.

CASH BOOT: Any proceeds actually or constructively received by the Exchanger.

CONSTRUCTIVE RECEIPT: Although an investor does not have actual possession of the proceeds, they are legally entitled to the proceeds in some manner such as having the money held by an entity considered as their agent or by someone having a fiduciary relationship with them. This can create a taxable event.

DIRECT DEEDING: Transfer of title directly from the Exchanger to Buyer and from the Seller to Exchanger after all necessary exchange documents have been executed.

EXCHANGER: Entity or taxpayer performing an exchange.

EXCHANGE AGREEMENT: The written agreement defining the transfer of the relinquished property, the subsequent receipt of the replacement property, and the restrictions on the exchange proceeds during the exchange period.

EXCHANGE PERIOD: The period of time in which replacement property must be received by the Exchanger; Ends on the earlier of 180 calendar days after the relinquished property closing or the due date for the Exchanger's tax return (If the 180th day falls after the due date of the Exchanger's tax return, an extension may be filed to be entitled to the full 180 day exchange period).

IDENTIFICATION PERIOD: A maximum of 45 calendar days from the relinquished property closing to properly identify potential replacement property or properties.

LIKE-KIND PROPERTY: Any property used for productive use in trade or business or held for investment; both the relinquished and replacement properties must be considered "like-kind" to qualify for tax deferral.

MORTGAGE BOOT: This occurs when the Exchanger does not acquire debt that is equal to or greater than the debt that was paid off on the relinquished property sale; Referred to as "debt relief". This can create a taxable event.

QUALIFIED INTERMEDIARY: The entity who facilitates the exchange; Defined as follows: (1) Not a related party (i.e. agent, attorney, broker, etc.) (2) Receives a fee (3) Receives the relinquished property from the Exchanger and sells to the buyer (4) Purchases the replacement property from the seller and transfers it to the Exchanger; Asset Preservation, Inc. (API) is a "Qualified Intermediary."

RELINQUISHED PROPERTY: Property given up by the Exchanger; Referred to as the sale, 'downleg' or 'Phase I'.

REPLACEMENT PROPERTY: Property received by the Exchanger: Referred to as the purchase, 'upleg' or 'Phase II'.

What Language Should be Added to the Contract in an Exchange?

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Although many Exchangers include language in their Purchase and Sale Agreement establishing their intent to perform an exchange, it is not required by the Internal Revenue Code.

CONTRACTS MUST BE ASSIGNABLE

It is important, however, that the Purchase and Sale Agreements for both properties are assignable. In order to structure a typical exchange transaction, Asset Preservation, Inc. (API) must be assigned in as the Seller of the relinquished property and also as the Buyer of the replacement property. An Exchanger should review the contract to confirm they are not prohibited from assigning their position as either a "Seller" or "Buyer" to a Qualified Intermediary. When a typical exchange is initiated by Asset Preservation, API is shown as the Seller on the Settlement Statement instead of the Exchanger being reflected as the Seller.

"LAST MINUTE" EXCHANGES ARE POSSIBLE

At Asset Preservation, many real estate investors contact our office *just minutes before closing on their transaction* and successfully convert a sale into an exchange. In most situations, a successful exchange can be accomplished as long as Asset Preservation is contacted prior to closing.

Many Exchangers and real estate agents add exchange language to the contract for a couple of reasons:

1. It establishes their intent to perform a §1031 tax deferred exchange;
2. To notify the other party in advance of the need to assign the contract to an Intermediary.

The language below is satisfactory to establish the Exchanger's intent to perform a tax deferred exchange and releases the other parties from costs or liabilities as a result of the exchange:

SALE OF RELINQUISHED PROPERTY

"Buyer is aware that Seller intends to perform an IRC Section 1031 tax deferred exchange. Seller requests Buyer's cooperation in such an exchange and agrees to hold buyer harmless from any and all claims, costs, liabilities, or delays in time resulting from such an exchange. Buyer agrees to an assignment of this contract by the Seller."

PURCHASE OF REPLACEMENT PROPERTY

"Seller is aware that Buyer intends to perform an IRC Section 1031 tax deferred exchange. Buyer requests Seller's cooperation in such an exchange and agrees to hold seller harmless from any and all claims, costs, liabilities, or delays in time resulting from such an exchange. Seller agrees to an assignment of this contract by the Buyer."

§1031 Exchanger Checklist

Working with Asset Preservation, Inc.

This checklist is intended to provide a brief overview of the steps involved in an IRC §1031 tax deferred exchange and when Asset Preservation, Inc. (API) should be contacted throughout the process. This checklist does not address all issues involved in an exchange. Please read all of the exchange documents prepared by API. As a Qualified Intermediary, API cannot provide tax or legal advice. Investors should always seek the advice of their tax and/or legal advisors regarding their specific situation.

- ☐ **1. REVIEW: Review the entire transaction with tax and/or legal advisors.**
- ☐ **2. SALE CONTRACT: Enter into an "assignable" contract to sell the relinquished property.**

  Execute contract with the exchanger's name and/or assigns.
- ☐ **3. CONTACT API: Before closing, contact API to initiate the exchange transaction.**

  A) Call either our National Headquarters (800-282-1031) or Eastern Regional Office (866-394-1031) *- or -*
  B) Go to apiexchange.com and click on: Open a New §1031 Exchange .
- ☐ **4. EXCHANGE SET-UP: API will prepare the exchange documents for the relinquished property sale.**

  A) The original documents will be forwarded to the closing officer who will coordinate the signatures.
  B) Copies of documents are forwarded to the exchanger.
- ☐ **5. RELINQUISHED PROPERTY CLOSES: API is assigned into the transaction as the seller and sale closes.**

  A) Pursuant to the assignment agreement and exchange documents, API instructs the closing officer to directly deed the relinquished property to the buyer.
  B) Exchange proceeds are transferred directly to API via wire transfer.
- ☐ **6. IDENTIFICATION PERIOD: Both the 45-day identification period and exchange period begin.**

  Although it is the sole responsibility of the exchanger to meet all identification rules, API will forward confirmation of the exchange proceeds received, the timelines for the 45-day identification period and 180-day (or the date the tax return is due, whichever is earlier) exchange period, the identification requirements and the identification rules.
- ☐ **7. PROPERTY IDENTIFIED: Exchanger properly identifies replacement property by midnight of the 45th day.**

  A) Specific written identification, signed by the taxpayer, is forwarded to API.
  B) Written identification can also be made to a party involved in the exchange transaction who is not a disqualified person. See the Treasury Regulations for more details on the identification requirements.
- ☐ **8. PURCHASE CONTRACT: Enter into an "assignable" contract to purchase replacement property.**

  Execute contract with the exchanger's name and/or assigns.
- ☐ **9. CONTACT API: After signing the replacement property contract, contact API.**

  A) Call your Exchange Counselor at the National Headquarters or Eastern Regional Office *- or -*
  B) Go to apiexchange.com: Click on Open a New §1031 Exchange, Purchase of Replacement Property.
- ☐ **10. EXCHANGE PAPERWORK PREPARED: API will prepare the exchange documents for purchase.**

  A) The original documents will be forwarded to the closing officer who will coordinate the signatures.
  B) Copies of documents are forwarded to the exchanger.
- ☐ **11. REPLACEMENT PROPERTY CLOSES: API is assigned into the transaction and purchase closes.**

  A) Pursuant to the assignment agreement and exchange documents, API instructs the closing officer to directly deed the replacement property from the seller.
  B) API wire transfers exchange proceeds to the closing officer.
- ☐ **12. COMPLETION: If all exchange funds are used to acquire the replacement property or properties, and all the exchange requirements are met, the exchange is complete.**

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