ASSET PRESERVATION INCORPORATED

The Power of Strategy™:

Mastering Advanced §1031 Exchange Concepts

Hosted by:

North Perimeter Chapter of GSCPA

Presented by:

William B. Hood, CPA

Division Manager

ASSET PRESERVATION INCORPORATED

Today's Presenter

Today's Topic:
Power of Strategy™
Presented by: William B. Hood, CPA

William B. Hood brings over a decade of tax and real estate industry experience and teaching tax related seminars to CPAs, Legal, Real Estate professionals and investors. Mr. Hood's experiences also include business development and consulting with 1031 Qualified Intermediaries as well as publishing articles on 1031 Tax Deferred Exchanges and various other business topics.

Mr. Hood is a graduate of Seton Hall University with a B.S. degree in Public Accounting. Mr. Hood is a Certified Public Accountant and is a member of the American Institute of Certified Public Accountants, Georgia Society of Certified Public Accountants, the Atlanta Commercial Board of Realtors, the Atlanta Board of Realtors and CREW. Mr. Hood has resided in the Southeast since 1984.

Course Outline

- Exchange Terminology
- IRC §1031
- Definition of Like-Kind Property
- Delayed Exchanges
- Multiple Property Exchanges
- Parking Arrangements
- The Reverse & Improvement Exchange
- Revenue Procedure 2004-51
- Choosing a Qualified Intermediary

§1031 Exchange Terminology

- Boot
- Cash Boot
- Constructive Receipt
- Direct Deeding
- Exchanger / Taxpayer
- Exchange Agreement
- Exchange Period
- Identification Period
- Like-Kind Property
- Mortgage Boot
- Qualified Intermediary
- Relinquished Property
- Replacement Property

Internal Revenue Code §1031

Non-Recognition of Gain or Loss
from Exchange Solely of Kind

"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."

Exceptions

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

Property Held for Sale

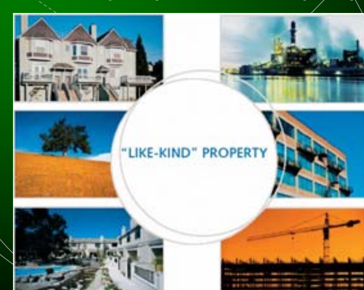
- The purpose for which the property was initially acquired
- The purpose for which the property was subsequently held
- The extent to which improvements, if any, were made to the property
- The frequency, number and continuity of sales
- The extent and nature of the transaction involved
- The ordinary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

Partnership Issues

- Is it a true partnership?
- Option #1: (swap and drop) Partnership stays intact and acquires replacement property; refinances later
- Option #2: (drop and swap) Election out of the partnership into separate undivided tenant-in-common interests
- Timing Issues

Definition of Like-Kind Property

Real Property for Real Property



Like-Kind Property Issues

- What is Excluded?
- Qualifying Real Property
- Qualifying Personal Property

Like-Kind Property Issues: Holding Period

- Time is only one factor
- The Taxpayer's intent is the key issue
- One Perspective: 24 months or more
  - In PLR 8429039, the IRS stated that a minimum holding period of two years would be sufficient.
- Second Perspective: Minimum of 12 months
  - Straddles two tax filing years.
  - Over 12 months qualifies for long-term capital gain treatment.
  - Attempt by Congress in 1989 to impose one year holding period (which didn't pass).

Like-Kind Property Issues: Vacation Homes

Revenue Procedure 2008-16

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

Requirements:

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

Like-Kind Property Issues: Vacation Homes

Barry E. Moore v. Comm., T.C. Memo. 2007-134

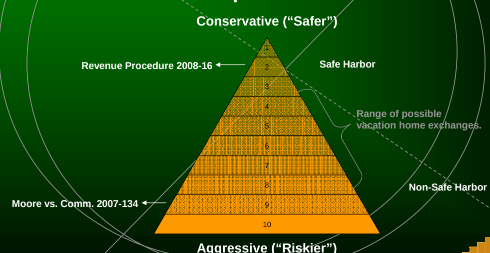
- The taxpayers never rented or attempted to rent the property
- The taxpayers deducted mortgage interest as "home mortgage interest" expense rather than investment interest expense.
- The taxpayers did not take (and probably did not qualify for) depreciation or other tax benefits associated with investment property, including deductions or maintenance expenses.

Planning Strategies

- Substantiate investment intent
- Report rental income, attempts to rent property or conversion from a second home to a rental property held for investment.
- Treat property as held for investment on the tax return

Like-Kind Property Issues: Vacation Homes

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



Like-Kind Issues: Tenant-in-Common Ownership

- What is a typical TIC investment?
- Advantages of a TIC investment?
- Risks involved in a TIC investment
- Revenue Procedure 2002-22

Like-Kind Issues: Tenant-in-Common Ownership

Revenue Procedure 2002-22

Does not provide a safe harbor for TIC programs.

Revenue Procedure offers:

- Guidelines for requesting advance rulings on specific co-ownership structures and proposed transactions
- Conditions present in proposed TIC structure under which IRS may consider a request for a ruling.

The Exchange Equation

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

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

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

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

Analysis: There is no boot.

The Exchange Equation

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

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

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

The Exchange Equation

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

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

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

Closing Costs

What Are Exchange Expenses?

- A direct cost of selling real property typically including:
  1. Real estate commissions
  2. Title insurance premiums
  3. Closing or escrow fees
  4. Legal fees
  5. Transfer tax and notary fees
  6. Recording fees
- Costs specifically related to the fact the transaction is an exchange such as the Qualified Intermediary fees.

Investor Motives

Investors increase their rate of return by using:

- Leverage
- Diversification
- Consolidation
- Cash flow
- Management relief
- Increase depreciation
- Estate planning

Cost Segregation

- What is Involved in a Cost Segregation Study?
- Benefits of a Cost Segregation Study:
  1. Reduced income taxes
  2. Reduced property taxes
  3. Reduced sales taxes
  4. Increased cash flow

Related Party Rules

- Who is a Related Party?
- Four Different Scenarios:
  1. Simultaneous Exchange (Swap)
  2. Delayed – Selling to a Related Party
  3. Delayed – Purchasing from a Related Party (See Rev. Ruling 2002-83, PLR 9748006)
  4. Delayed – Purchasing from a Related Party who is Exchanging (See PLR 2004-40002)

Internal Revenue Code §121

- Married taxpayers, filing a joint return, can exclude up to $500,000. Single filers can exclude up to $250,000
- Gains in excess of $500k are taxed at 20%
- Home must be primary residence of both spouses for 2 of the last 5 years
- §121 exclusion available once every two years
- Vacation/second homes do not qualify
- Jobs and Growth Reconciliation Act

Treasury Decision 9152

- Taxpayers may exclude gain from principle residence even though they have owned it for less than two years.
- Maximum exclusion applies only if the sale is by reason of:
  1. Change in place of employment (50 miles)
  2. Health of certain qualified individuals
  3. Unforeseen circumstances (death, divorce, multiple births from same pregnancy, unemployment or change in employment, etc.)

American Jobs Creation Act-2004

Sec. 810: "Recognition of gain from the sale of a principle residence acquired in a like-kind exchange within 5 years of sale. (10) PROPERTY ACQUIRED IN LIKE-KIND EXCHANGE – If a taxpayer acquired property in an exchange to which section 1031 applied, subsection (a) shall not apply to the sale or exchange of such property if it occurs during the 5-year period beginning with the date of the acquisition of such property."

Revenue Procedure 2005-14

- Take advantage of §121 (tax exclusion on a primary residence) and §1031 (tax deferred exchange treatment) when a property was a primary residence for 2 of the last 5 years, but most recently held for investment purposes.
- Allows both capital gain tax exclusion – and deferral – which benefits homeowners with gain over the $500,000 and $250,000 limits.

§1031-§121 Split Treatment

Sale of a Fourplex

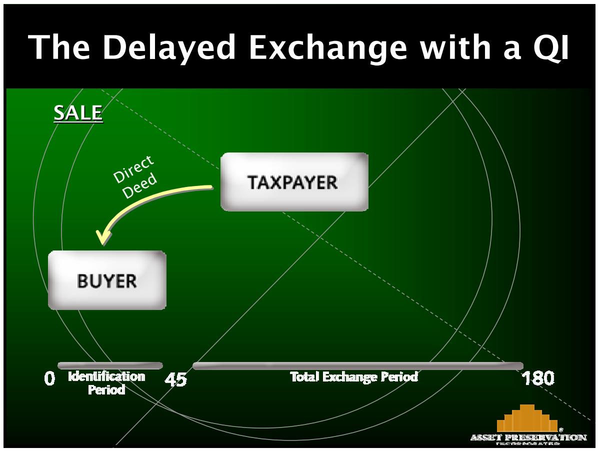
- 3 units rented
- 1 unit primary residence

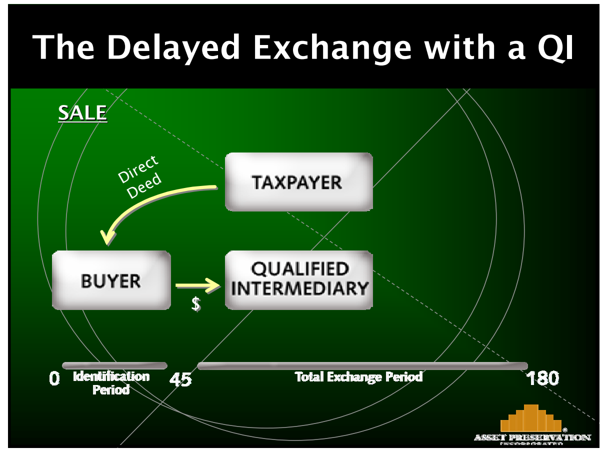
- §1031 – ¾
- §121 – ¼

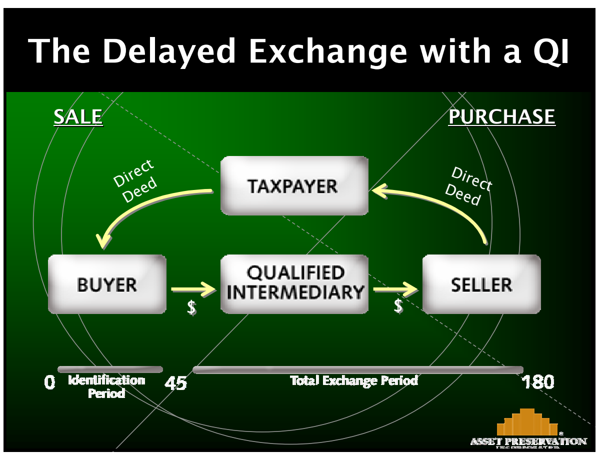
§1031	§1031
§1031	§121 Primary Residence

§1031 Exchange Formats & Variations

- Two-Party Trade (swap)
- Three-Party Format ("Alderson")
- The Delayed Exchange with a QI
- Multiple Sales and Acquisitions
- The Reverse Exchange
- The Improvement Exchange







Delayed Exchange - Time Requirements

- **45 Day Identification Period:**
  The Taxpayer must identify potential replacement property(s) by midnight of the 45th day from the date of sale.
- **180 Day Exchange Period:**
  The Taxpayer must acquire the replacement property by midnight of the 180th day, or the date the Taxpayer must file its tax return (including extensions) for the year of the transfer of the relinquished property, whichever is earlier.

Delayed Exchange – Identification Rules

- **Three Property Rule:** The Taxpayer may identify up to three properties of any fair market value.
- **200% Rule:** The Taxpayer may identify an unlimited number of properties provided the total fair market value of all properties identified does not exceed 200% of the fair market value of the relinquished property.
- **95% Rule:** If the Taxpayer identifies properties in excess of both of the above rules, then the Taxpayer must acquire 95% of the value of all properties identified.

Delayed Exchange – Identification Rules

Identification must be:

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

Restrictions on Exchange Proceeds 1.1031(k) – 1(G)(6)

In a deferred exchange, U.S. Treasury Regulations, Section 1.1031 (k)-1(g)(6), require stipulations in the exchange agreement which limit the Taxpayer's ability *to receive, pledge, borrow or otherwise obtain the benefits of money or other property before the end of the exchange period. The Exchanger may have rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property upon or after:*

(a) The receipt by the Taxpayer of all replacement property to which the taxpayer is entitled under the exchange agreement

(b) The occurrence after the end of the identification period of a material and substantial contingency that —

(1) Relates to the deferred exchange,

(2) Is provided for in writing, and

(3) Is beyond the control of the Taxpayer and of any disqualified person (as defined in paragraph (K) of this Section), other than the person obligated to transfer the replacement property to the taxpayer."

Restrictions on Exchange Proceeds 1.1031(k) – 1(G)(6)

- Section 1.1031(k)-1(g)(6)
- Scenario #1
  (Multiple properties within the ID Period)
- Scenario #2
  (Multiple properties outside the ID Period)

Highlights of a Valid Delayed Exchange

1. Establish the Taxpayer's intent
2. Consult with an experienced QI and tax/legal advisor prior to closing the sale of the relinquished property.
3. Ensure that the Sale Contract is assignable and that they Buyer is <u>made aware</u> of such <u>assignment</u> in writing.
4. The following language is to establish three things:
   a) Intent to effect a §1031 tax deferred exchange
   b) Release the Buyer from any liabilities or costs resulting in the exchange;
   c) Notify the Buyer in writing of assignment.

Highlights of a Valid Delayed Exchange

5. The QI's Exchange Agreement must be executed prior to closing the sale. QI oversees the closing.
6. The QI should oversee the closing to ensure §1031 is properly reflected.
7. The taxpayer must identify the property(ies) to be acquired in accordance with the Rules of Identification.
8. The taxpayer must close on the new property by the 180th calendar day (or their tax filing date – whichever is earlier) from the close of the relinquished property sale.

What Not to do in a Delayed Exchange

- Christensen vs. Comm. (April 10, 1998)
  (Didn't file extension to obtain full 180 days)
- Knight vs. Comm. (March 16, 1998)
  (Closed after the 180th day)
- Dobrich vs. Comm. (October 20, 1997)
  (Backdated the Identification Notice)

Choosing a Qualified Intermediary

The most critical choice you'll ever make in a §1031 exchange

Interview several and take special note of the Fund Management Program

Choosing a Qualified Intermediary

Paramount to every exchange is the safety of the funds held by the Qualified Intermediary

Your careful scrutiny is required!

Choosing a Qualified Intermediary

- In whose name are funds held?
- Are separate accounts set up for each client?
- Requirements for deposit and withdrawal?
- Where (institution) are funds held?
- Is the Qualified Intermediary insured by a much larger parent company? (i.e., a title company)
- What security can be provided in writing?

Appendix

- A - Seller Financing
- B - Replacement Property Basis
- C – Exchange Entities
- D - IRS Form #8824

For more information, contact:

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