The Newsletter of

1031 Exchange Services

EXCHANGE *with* **CONFIDENCE**

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You can exchange one investment property for two (or more) investment properties.

■ You can exchange two (or more) investment properties for one more expensive replacement property.

■ If you need to take some cash out of your sale property, you can do so and still defer capital gains taxes on the remainder of your profit. This technique is known as a "partially taxable exchange", which allows you to use some of the sale proceeds to pay bills, while still accomplishing substantial tax savings on the remainder by reinvesting it through a qualified intermediary.

■ Tax-Saving Tip: A better way to take cash out of your exchange would be to wait until you buy your replacement property, then refinance it. The borrowing of money is not a taxable event, so long as the borrowing does not occur on the same day or as part of the same closing in which you buy your replacement property.

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Did You Know?

You can exchange one investment property for two (or more) investment properties

At 1031 Exchange Services, we believe:

Tax-free exchanges under Sec. 1031 are the cornerstones for building and maintaining wealth in real estate.

Sellers of real estate, who intend to re-invest in real estate, should never pay capital gains taxes.

A tax-free exchange under IRC Sec. 1031 may be the easiest way that any taxpayer can save significant tax dollars literally "at the stroke of a pen"

The use of a professional, full service, full-time qualified intermediary is the best way for the real estate investor to maximize the benefits of a like-kind exchange.

■ You can exchange out of non-income producing raw land (usually having a negative cash flow) into income-producing improved land (positive cash flow), without paying capital gains taxes. This qualifies as a "like-kind" Sec. 1031 Exchange because it is an exchange of investment property for investment property.

■ You can buy a fractional interest as replacement property in your exchange. For example, if you were to sell, through an exchange, a building worth $150,000, you could buy a 50% interest in a $300,000 building, and your new one-half interest would count as your replacement property.

■ Tax-saving Tip: When selling rental real estate in an exchange, you should always transfer the security deposits and rents paid in advance to your buyer by separate check at the closing, not by credit (deduction) on the closing statement. If you give a credit for these items on the closing statement, you will be liable for ordinary income taxes in the amount of the credit.

■ The Intermediary in an exchange cannot be the Taxpayer's employee, attorney, accountant, or real estate agent (Treasury Reg. Sec. 1.1031(k) – 1(k) – "Definition of Disqualified Person"). An exchange that is done with a disqualified person or entity as the Intermediary will not pass an audit.

The 1031 Q&A Forum

For information and advice on any 1031 Exchange issues, call 401-331-0083.

Improvement exchanges, if done correctly, will defer capital gains when you sell a property or properties for more than the unimproved land you buy.

Q I would like to defer all capital gains taxes on the sale of my building, which is worth $250,000 and which has a very small basis and no mortgage. I have found the perfect replacement property, an unimproved piece of real estate which I could buy for $100,000 and then construct a building on it for $150,000. Can I accomplish a valid 1031 exchange this way?

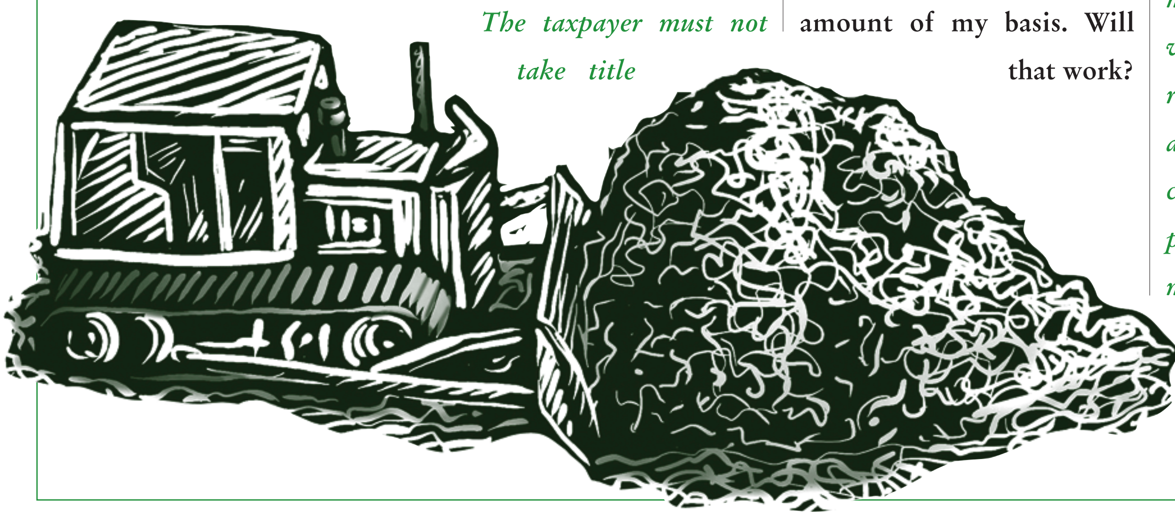
A *Yes, this taxpayer can defer all capital gains taxes, by performing what is known as an "improvement" exchange. An improvement exchange must be done in a technically correct manner, however, or it will result in taxability. The taxpayer must not take title to the new property until after the improvements are completed. Under IRS RevProc 2000-37, this is usually accomplished by the Qualified Intermediary forming a special purpose LLC to buy and hold title to the targeted replacement property until the desired improvements can be done, at which time the newly improved property is transferred to the taxpayer in the second leg of the taxpayer's exchange.*

Q I am selling my investment property for $200,000. My capital gain will be $90,000. I would like to defer all taxes by buying a property for $110,000, which is the amount of my basis. Will that work?

A *No. This proposed "exchange" will not result in the non-recognition of capital gain. Taxpayers must buy a property that costs equal to or greater than the sale price of their old property (minus selling expenses), if they want to accomplish a totally tax-free exchange.*

Q I am selling for $200,000, but I will be paying off a mortgage of $75,000. I would like to defer all capital gains by reinvesting my net cash proceeds into a building costing $125,000. Will that accomplish a tax-free exchange for me?

A *No. This is another common misconception. The taxpayer who has mortgage relief at the relinquished property closing, and who merely reinvests the cash from the relinquished property without replacing the mortgage that was paid off, will not defer all capital gains taxes.*



Q I will be selling for $200,000, with a broker's commission of $12,000, sales expenses of about $3,000, and I will be paying off a mortgage for $75,000. My basis is $100,000. What will I have to spend to defer all capital gain taxes?

A *This taxpayer will defer all capital gains taxes by buying a replacement property worth $185,000 or greater. The target reinvestment amount, in order to defer all taxes, is simply the net selling price, that is, the sale price minus true selling expenses. The basis, gain and mortgage do not figure into the calculation of the target reinvestment price.*

WHAT IS A "REVERSE" EXCHANGE?

A reverse exchange occurs when the investment property owner must acquire the replacement property before the closing on the relinquished property. The IRS does not recognize a "pure" reverse exchange, which means that the taxpayer cannot take title to the replacement property in his own name (or in the name of a relative or agent) before disposing of the relinquished property. The IRS will approve and grant "safe harbor" status, however, to a reverse exchange if title to either the replacement property or the relinquished property (usually the replacement property) is held by an Exchange Accommodation Titleholder ("AT") pursuant to a Qualified Exchange Accommodation Agreement in compliance with RevProc 2000-37. A typical "safe harbor" reverse exchange under the RevProc would proceed as follows:

1. The taxpayer ("Exchangor") enters into a purchase and sale agreement to buy an investment property (the "replacement property"). If the Exchangor can close on the sale of his relinquished property before closing on the purchase of the replacement property, the exchange is a regular one, or "straight ahead". If the relinquished property cannot be sold first, the Exchangor arranges with a Qualified Intermediary for title to the new property to be purchased and held by a newly-formed, special purpose LLC, or AT.

2. At the closing for the replacement property, the Exchangor or a third-party lender provides all of the funds for the acquisition by the AT. The AT provides the Exchangor (or the third-party lender) with a non-recourse note and mortgage for the full amount of the purchase price. If a third party lender is involved, the Exchangor personally guarantees the note.

3. The AT triple-net leases the replacement property to the Exchangor for $1.00 per month, or the amount of the third party financing, if any. The Exchangor receives all income and deductions from the property (but not depreciation deductions) during the "parking" period.

4. The Exchangor enters into an Agreement for a Deferred Exchange with the Qualified Intermediary. Within 180 days, the Exchangor sells the relinquished property pursuant to the exchange agreement. The QI utilizes the relinquished property proceeds to acquire the Replacement Property from the AT. At this closing the mortgage to the Exchangor or third party is paid off. Title to the Replacement Property is deeded directly from the AT to the Exchangor, completing the safe-harbor reverse exchange.

5. The Exchangor reports the exchange as a straight ahead exchange on Form 8824 and defers all federal and state capital gains taxes on the sale of the relinquished property, the proceeds of which have been effectively reinvested in the new Replacement Property.

Materials herein have been prepared by Charles J. Ajootian, Esq., President of and Counsel to 1031 Exchange Services, Inc., a Providence, RI based Qualified Intermediary firm which engages in tax-deferred exhcanges throughout the United States. The materials herein should not be considered a substitute for competent professional advice concerning your particular exchange.

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