The Newsletter of

1031 Exchange Services

EXCHANGE *with* **CONFIDENCE**

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Tax Calculations Involving Investment Real Estate

Estimating Capital Gains

How much would I have to pay in taxes if I sold my appreciated investment property without doing an Exchange?

The starting point to estimate your potential capital gains taxes is to determine your "profit", which the Internal Revenue Code calls *"realized gain"*. The formula to determine realized gain is the "true" sale price minus the adjusted basis of the property:

Note 1: The True Sale Price equals the contract sale price of the asset, minus only "true sale expenses", sometimes referred to as transactional expenses, which include closing cost credits to the Buyer, transfer taxes (stamps on deed), broker commissions, legal fees, recording fees, and exchange fees.

Note 2: The Adjusted Basis of the asset is the original acquisition cost, minus accumulated depreciation (allowed or allowable), plus the cost of capitalized (not deducted) improvements.

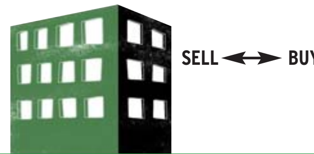
True Sale Price – Adjusted Basis = Realized Gain
(see Note 1) (see Note 2) (Profit)

EXAMPLE:

True Sale Price:	$250,000	(contract sale price)
	-15,000	(brokerage commission)
	– 2,500	(other sale expenses)
	= $232,500	(true sale price)
Adjusted Basis:	$120,000	(original acquisition cost)
	-15,000	(depreciation)
	+ 0	(capitalized improvements)
	= $105,000	(adjusted basis)
Realized Gain:	$232,500	(true sale price)
	-105,000	(adjusted basis)
	= $127,500	(realized gain – PROFIT)

{Note that the profit on a sale of real estate is computed without regard to the amount of any mortgage that may be outstanding on the property.}

EXCHANGES MAKE CENTS



The Golden Rule of Exchanges

In order to defer all taxes in an investment real estate exchange, you must trade equal or up in equity and value.

Estimating Capital Gains Taxes

If the realized gain (profit) on the sale of my real estate is $127,500, what is my tax liability if I do not do an exchange?

The federal capital gains tax is capped at 15% for most taxpayers who are not in the lowest income brackets. However, the gain attributable to depreciation allowed or allowable is taxed at 25% (this rate was not affected by the latest tax reduction act). Therefore, the federal tax on the first $15,000 of gain would be approximately $3750; the federal tax on the balance of the gain ($112,500) would be approximately $16,875. Thus the total federal tax owed would be approximately $20,625. The tax liability to the State of Rhode Island (most states are similar) would be at least 5% of the realized gain, or in this case approximately $6,375. Thus the total federal and state capital gains tax liability would be $20,625 plus $6,375, or at least $27,000.

In this example, if the investment property owner does an exchange instead of a sale, and acquires investment real estate costing $232,500 or greater, he or she will have a realized gain of $127,500 but the gain will not be recognized for income tax purposes, that is, it will not be taxable, and the taxpayer will be able to put an extra $27,000 to use in acquiring the next property.

see **Tax Calculations**
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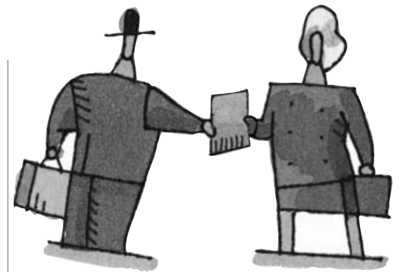
Practical Guidance on Purchase and Sale Agreements in Exchanges

Many people ask whether there is a requirement to insert special "exchange language" in their purchase and sale agreement, in order to qualify for a tax-free transaction. There is a great deal of misinformation on the internet and elsewhere concerning this subject. The simple answer is: "No." Not since 1991 has there been any requirement to insert an exchange clause. The IRS requires an "Exchange Agreement" (a totally separate document which the Intermediary prepares after the P&S is signed) to be in place between the taxpayer and an Intermediary, to be signed on or before the date of the relinquished property closing. **The exchanging party does not need the cooperation, participation or consent of his or her Buyer or Seller in order to qualify the transaction as a tax-deferred exchange.**

Prior to 1991, when Treasury Regulations (Treas. Reg. Sec. 1.1031(k)-1, et seq.) were issued which govern Exchanges to this day, there *was* a requirement to include exchange language in a purchase and sale agreement involved in an exchange. The 1991 Regulations changed that by setting forth the several elements necessary for a "safe harbor" exchange. Special exchange language in the sale contract is *not* one of the necessary elements specified in the Regs.



Even though the IRS does not require a special clause in the sale contract, it is not wrong to include one when the Exchangor is **selling**, and we do see many sale agreements (but probably less than half that we deal with) which include some type of exchange language. Many times the exchanging party and/or their advisors are more comfortable having an exchange clause in the agreement. Sometimes they are unaware of the impact of the 1991 Treasury Regulations. If either is the case, then we recommend the use of the highlighted clause, which is designed to put the Buyer at ease so as not to jeopardize the underlying transaction. We strongly recommend against using an exchange clause when the Exchangor is buying because it gives the savvy Seller too much bargaining power.

When Exchangor is **SELLING**:

Seller at his sole expense intends to assign his rights in this Agreement to 1031 Exchange Services, Inc., which will in no way affect the rights or obligations of Buyer, in order for Seller to initiate a Section 1031 Tax-Deferred Exchange. Seller will deed the subject property directly to Buyer at closing. Buyer consents to said assignment.

When Exchangor is **BUYING**:

DO NOT INSERT AN EXCHANGE CLAUSE. YOU GIVE AWAY TOO MUCH IN BARGAINING POWER IF THE SELLER KNOWS YOU ARE DOING AN EXCHANGE.

Exchanging out of, or into, a Second Home ("Vacation Home")

In many areas, vacation or second homes have appreciated as much or more than primary residences and commercial properties. The first question is whether the owner of an appreciated vacation home can avoid capital gains taxes by selling and acquiring replacement property via a Section 1031 exchange.

To qualify for non-recognition of gain under Section 1031, the relinquished property must be held for use in a trade or business, or for investment. In the most common situation (i.e., where the owner uses the second home strictly for his or her personal or family use, never renting out the property), conventional wisdom is that the second home is an extension of the taxpayer's residence, and thus is not held for productive use in a trade or business, or for investment. Thus, in the most common situation, the second home would not qualify as potential exchange property. *There is a minority view, however, that even without rental history, if the taxpayer can state that they acquired and held the property with an intention to benefit from its appreciation in value, and if their use of the property was minimal (perhaps under two weeks per year), then they can make a case for exchanging their second home.* This view being a minority view should suggest that it is not without risk.

Sometimes the taxpayer owns a second or vacation home which they rent out for part of the year. If the property is rented more than incidentally (not defined anywhere in the tax code), the property will qualify as investment property, so long as the taxpayer's use of the property is minimal, *which is usually defined as no more than 14 days per year, or no more than 10% of the number of days the property is rented out, whichever is greater.* This type of second or vacation home is a proper candidate for a tax-deferred exchange under Section 1031.

What about acquiring in an exchange, a property to be used as a second home or vacation home? In a limited way, this can be accomplished. So long as the taxpayer's use of the property is within the limits of the 14 day/10% test, and so long as the taxpayer does rent out the property, the property can properly be a replacement property in an exchange.

Can the taxpayer ever change the use of a replacement property (that is, stop renting out the property), without incurring an adverse tax impact? Yes, so long as the taxpayer rents out the property for at least the first two years after acquisition. The IRS has recognized that after a two year or more rental history, the taxpayer has proven that they acquired the property with the intent to hold for investment. A "change in use" after that time will not cancel out the exchange, and will not result in the issuance of a tax bill for the original capital gains. Many people who own vacation homes started out exchanging small investment properties. Their final exchange was into a Florida or New Hampshire property. After renting the property out for two years, they have changed the use of the property, and can now look back and say that they were able to acquire their vacation home because of wise use of Section 1031.

Tax Calculations

(continued from page 1)

Special Note on a potential "hidden" adverse tax impact when selling investment real estate without doing an exchange: if capital gains taxes are recognized (if no exchange is accomplished), the capital gains (profit) must be added to the taxpayer's adjusted gross income (AGI). The added capital gains will raise the "floor" above which the taxpayer will be allowed to take a number of itemized deductions. This often results in a large decrease or total loss of those deductions. Also, the increased AGI that occurs when the capital gains are added will be taken into account in computing the phase-out of personal exemptions. Again, for many taxpayers this results in a large loss of deductions. This "hidden" capital gains liability can be significant and is of course in addition to the stated federal and state rates.

COMPLIMENTARY BOOKLET

Call Charles J. Ajootian, Esq.
@ 401-331-0083 for your free copy.

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 exchanges 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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