

Remember....."You can have everything in life you want, if you just help enough other people get what they want." -Zig Ziglar.

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### ***My Special Circumstance — Facts Are Important***



Understanding the direction of the path, the past events, and the desired result or position is crucial for your success. Please assist by visiting with us so that we understand and know your needs. Although you are the Captain and control your circumstances, we are your navigators and must know about you.

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## My Special Circumstance — Understanding My Plan

### Preface – What This Is About

To help you to better understand the “Like-Kind Exchange” opportunity for deferring income tax on the sale of a building, a condensed and simplified explanation is furnished to you herein. Following the executive summary is a “Fact Sheet and Organizer” for your use in preparing for the exchange.

### Executive Summary

#### Tax Killer



A sale will yield a gain or loss depending on the amount realized on the asset and the taxpayer's basis for it.



Under the like-kind exchange rules of Code Section 1031, an exchange of like-kind property will result in neither gain nor loss recognition, and the new asset's basis will equal the old asset's remaining basis, plus any cash paid to trade up.



The exchange will kill the tax for the current trade. The strategy will defer all the tax on the current transaction. If the property acquired in the exchange is converted to cash in the future, there will be tax due at that event.

#### Is This Strategy Suitable For Me?

Simplified Decision Table		
Circumstance	Yes	No
Is the real estate you intend to sell something other than your personal residence or real estate you recently acquired?		
Do you intend to use the money received from the sale of your real estate to acquire new real estate which will not be used as your new personal residence or immediately resold?		
Will you make a profit when you sell your real estate?		
Do you want to defer paying income tax your profit?		
If you answered yes to each of these questions then you should seriously consider structuring your transaction as an IRS 1031 Tax Deferred Exchange. You will have the same freedom as if you had simply "sold" your old real estate and "purchased" your new real estate.		

## 1031 Exchange Process

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**Basic Requirements for 1031 Exchange.** A Section 1031 exchange allows you to exchange certain property interests for interests of "like kind" without having to pay capital gains tax on the exchange. Since you have real property owned in fee simple to exchange, the replacement property "like kind" property would be fee simple (and certain long term leasehold real property). The replacement property must either be acquired for trade or business purposes or for investment purposes. The replacement property cannot be acquired for personal use purposes (your personal residence) or for resale (inventory). Because real estate is involved, your replacement property can be improved or unimproved real estate. The improvements can range from residential structures, fee simple condominium apartments, to commercial or industrial structures.

**Boot.** The basic idea in a 1031 exchange is to defer the recognition of taxable gain because you are exchanging property. This does not work if you are not exchanging like kind property. If you receive cash from the transaction, you are obviously not exchanging property since you are receiving money. Section 1031 therefore provides that when you receive (or have the right to receive) cash, that you will be deemed to receive "boot" and be taxable up to the lesser of either the boot received or the total capital gain on the transfer. Property which is not "like kind" will also be "boot". In a real estate exchange, personal property items such as furniture will be boot as to the real estate. Mortgage relief will also be included in "boot". For mortgage relief boot (but not for cash boot), it is possible to offset the boot by either assuming mortgage on the replacement property or by acquiring more replacement property than the amount of exchange proceeds.

### **Warning**

The receipt of money or property that is not like-kind to the property relinquished in addition to the receipt of replacement property is the receipt of boot and results in the recognition of at least a portion of any gain.

The actual or constructive receipt of money or non-like-kind property after the transfer of the relinquished property but before the receipt of the replacement property may disqualify the transaction from non-recognition treatment.

**Deferred Section 1031 Exchange.** Although a simultaneous exchange is possible, most exchanges are done using an exchange intermediary ("exchange company") so that the first part of the exchange can close without waiting for the replacement property to be acquired. The intermediary is substituted for the owner so that the exchange company actually deeds the property to the first buyer. The exchange company is paid the money from the sale and holds that money until the owner finds suitable replacement property and signs an agreement to buy that property. At that point, the exchange company is substituted so that it buys the replacement property with the funds it is holding.

There are now detailed IRS rules that describe how deferred 1031 exchanges must work. Using an exchange company is probably the easiest way of complying. Because the exchange company will be holding large sums of money and your only rights against the company are under the exchange agreement, I prefer dealing with an exchange company that is associated with an escrow company. It is possible to structure some forms of security with respect to the exchange transaction, but that would involve special documentation and the cost of setting those up will probably more than offset the savings in using non-escrow related companies. You may choose any exchange intermediary you find is suitable.

One variation in a deferred exchange is to "direct deed" the exchange and replacement properties; i.e., you would convey directly to the buyer of the exchange property and would receive title directly from the owner of the replacement property. The advantage is that you can avoid the second conveyance tax on both the exchange property and the replacement property. Since the IRS regulations are very specific on qualifying direct deed transactions, we need to be careful about the wording and mechanics of direct deed transactions.

O:\BPCPA PC\Checklist Modules\Capital Gains and Losses - Like Kind Exchanges 1031\Like Kind Exchange Client Copy.doc

There is more leeway if the title is passed through the exchange company and I was reluctant to use direct deeding, but the conveyance tax cost is a factor so unless you direct otherwise, I will set up the exchange for direct deeding.

### 45 Days Limit

Deferred exchanges involve two deadlines with which you must comply. The first is the 45-day deadline in which you must identify the replacement property. The identification is made to the exchange company and must be in writing signed by the taxpayer. You may identify more than one property and if you are not sure that you can get a property, you may identify alternate properties. However, under the IRS rules, if you identify more than three properties, there are some calculations that need to be made to be sure that you do not disqualify the identification. The 45 days run from the time that the exchange property closes.<sup>1</sup>

### 180 Days Limit

The second deadline is a bit trickier. You will have the shorter of 180 days or the time when you timely file your Federal income tax return in which to close the purchase of the replacement property. If you need the additional time to complete the acquisition (past April 15, 2000), you must apply for the 4-month automatic extension for filing your Federal income tax return (Form 1040) even if you could otherwise file the return. By doing so, you will have up to the 180-day limit to acquire the replacement property. The acquisition period starts as of the closing of the exchange property and not at the end of the 45-day period.

**There are no extensions on either of these two deadlines, so you must be sure to comply.**

**Tax Basis and Gain/Loss Realized.** You should determine your tax basis in the exchange property. The potential gain (or loss) on the exchange is the difference between the sales price of the exchange property (less selling expenses) and the tax basis. If Section 1031 applies, that gain or loss is not recognized unless there is "boot". If "boot" exists, then a portion of the gain or loss will be recognized. If the "boot" is cash, the gain or loss will be recognized to the extent of the cash. If "boot" is mortgage relief, the gain or loss will be recognized up to the "net boot" amount. When you do a 1031 exchange, your tax basis in the replacement property will be the same as your basis in the exchange property plus an amount equal to additional payments made to acquire the replacement property and amount of mortgage assumed. This means that you may have little or no depreciation on the replacement property since you cannot take depreciation in excess of your tax basis.

**Cost of Exchange.** The exchange company will charge you a fee for services. The typical fees involve a minimum charge which may be increased by a percentage of the exchange property sales price. There is usually an additional charge if more than one replacement property is involved and there may be a monthly charge for each month that the exchange remains open. The exchange company should have a schedule showing those fees. The typical charges for a single exchange property and single replacement property would be about \$500. In addition, the company may keep all of the interest earned on your funds.

### Caveats

1. Calendar and monitor the time limits
2. Prepare for cash required for your closings
3. Study the appraisals and fair market values carefully — both for your property being sold *and* for any property being acquired. Appraisals are only opinions. Usually the opinions are biased. Sometimes with malicious intent. Protect yourself. Comparable sales are usually limited in quantity to a few comparisons. Those chosen can be chosen to increase or decrease a property's appraised value — and this can work for you or against you.
4. Investigate the target property to be acquired carefully and ask Bob Parrish CPA for checklists or advisory sessions
5. Contracts should be prepared for potential liens on property purchased

6. Work with Bob Parrish CPA on the qualifications of the property to be received for the like-kind exchange rules
7. Fund investment accounts for the tax deferred if you plan to sell the property received in the future

## **Actions I Must Complete**

**Step 1** Discuss your exchange with Bob Parrish CPA. Decide whether this strategy is suitable for you. Set your objectives for the property to be received in the exchange. Prepare for the cash you will need for closings.

Choose a realtor and discuss

Establish dates for identifying property you will accept in the exchange

Choose legal counsel

Choose an exchange intermediary

**Step 2** Make sure that the real estate contracts have the 1031 terminology in the contract that allows for the assignment & indicates your intent to do an exchange.

Sample Terminology for Real Estate Contracts:

"Both the Seller and the Buyer hereto agree to cooperate with each other in a manner necessary to enable either party to qualify for a IRC Section 1031 tax-deferred exchange at no additional cost or liability to either party. Either party's rights and obligations will be assigned to "name of intermediary" to facilitate such exchange."

**Step 3** New property must be identified within 45 days of the closing of the old property.

**Step 4** Acquisition of the new property must be completed within 180 days of the closing of the old property.

Bob Parrish CPA PC has several educational sessions available if you would find a need for any of them:

1. Choosing locations
2. Preparing for closing costs – buyer's and seller's responsibilities
3. Styles of titles (types of ownership)
4. Bargaining
5. Mortgages
6. Finding money in retirement plans and IRA's
7. Understanding the appraisal process — how it can affect your equity, how you can control the process, or find another appraiser
8. Preparing property for sale

## Fact Sheet and Organizer

Information Required	Information - or attached hereto?	
	Property Sold	Property Acquired
Special Transaction		
Description of Property		
Use of Property Sold		
Legal Descrip, State and County		
Address		
Owner of Property		
For property you currently own - Date Acquired		
Method of Acquisition & Date Acquired		
Basis		
Trade Date		
Expenses of Sale		
Property Tax Role FMV		
Appraisal FMV		
Recent Comparable Sales Amounts		

### Proof The IRS Requires

Normally the laws will require substantiation of the following:

1. Property given in the exchange
  1. Ownership
  2. Acquisition details, including how it was acquired, date of acquisition, amount paid, records of depreciation or non-recognition of income. If the property

was acquired in any transfer that was not a purchase, other information will be required.

3. Description and use of the property
  4. Date of the sale
  5. Copy of closing statement
  6. Copy of records of exchange from the intermediary
  7. Perhaps property tax receipts or records
2. Property received
1. Ownership
  2. Description and use of the property
  3. Date of the purchase
  4. Copy of closing statement
  5. Copy of records of exchange from the intermediary - for example, date the property was identified, date of the possession, etc.
  6. Perhaps property tax receipts or records



## Contact Information

941-387-0926

941-387-7191

941-383-6595

432-367-3465

## End Notes

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<sup>1</sup> The first requirement is that the property to be received in exchange for other property must be specifically identified on or before the 45th day after the date of the transfer of the property that is relinquished in the exchange. [Code Section 1031\(a\)\(3\)\(A\)](#). If more than one property is relinquished as a part of the exchange, the period within which the property to be received must be identified begins as of the date of transfer of the first of such properties relinquished. [Reg. Section 1.1031\(k\)-1\(b\)\(2\)\(iii\)](#). In all events, however, property that is actually received in exchange before the end of the identification period will be treated as having met the identification requirement. [Reg. Section 1.1031\(k\)-1\(c\)\(1\)](#). See [Section 89.4\(d\)](#) for a discussion of the extension of the period as a result of the terrorist attacks of September 11, 2001.