Negotiating and Completing an Exchange

NEGOTIATING

AND

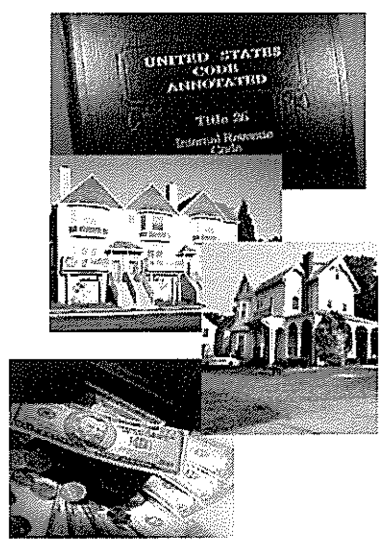
COMPLETING

AN

EXCHANGE

What is a 1031 Exchange?

- Section 1031 of the Internal Revenue Code
- Dispose of Relinquished Property
- Acquire Replacement Property
- Defer taxes on capital gains / accumulate more assets



Tax Calculations

To Calculate Net Adjusted Basis:

Original Purchase Price $________

plus Improvements +$________

minus Depreciation -$________

NET ADJUSTED BASIS $________

To Calculate Capital Gain Sales Price of Property:

Sales Price $________

minus Net Adjusted Basis -$________

minus Costs of Sale -$________

CAPITAL GAIN $________

Tax Calculations

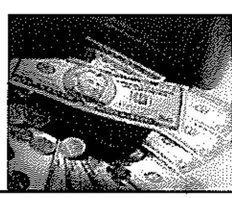
To Calculate Capital GainTax Due:

Recaptured Depreciation (25%) $_______

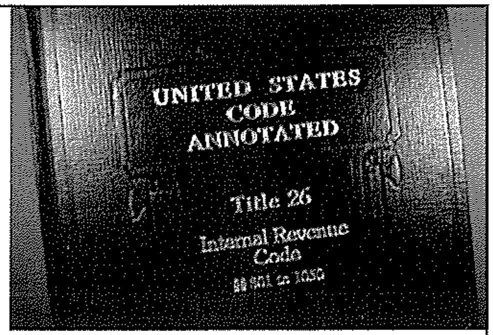
plus Federal Capital Gain Tax Rate (maximum of 15%) +$_______

plus state capital gain tax rate (enter applicable rate) +$_______

TOTAL TAXES DUE $_______



IRC § 1031(a)(1)



No gain or loss is recognized where property held for ***productive use in a trade or business or for investment*** is exchanged solely for property of ***like kind*** which is to be held for productive use in a trade or business or for investment.

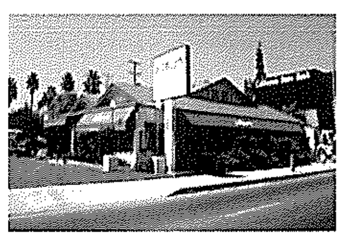
Qualifying Property

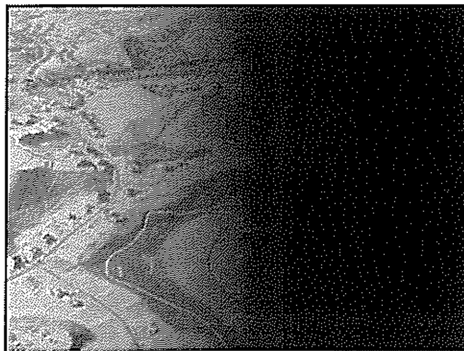
Property must be held for:

- For investment purposes

or

- For productive use in a trade or business





Non-Qualifying Property

Property can't be:

- Used as a primary residency
- Held primarily for sale (dealer property)

More Non-Qualifying Property

- Excluded under 1031(a)(2)
  - Stock in trade or other property held primarily for sale
  - Stocks, bonds or notes
  - Other securities or evidence of indebtedness or interest

More Non-Qualifying Property

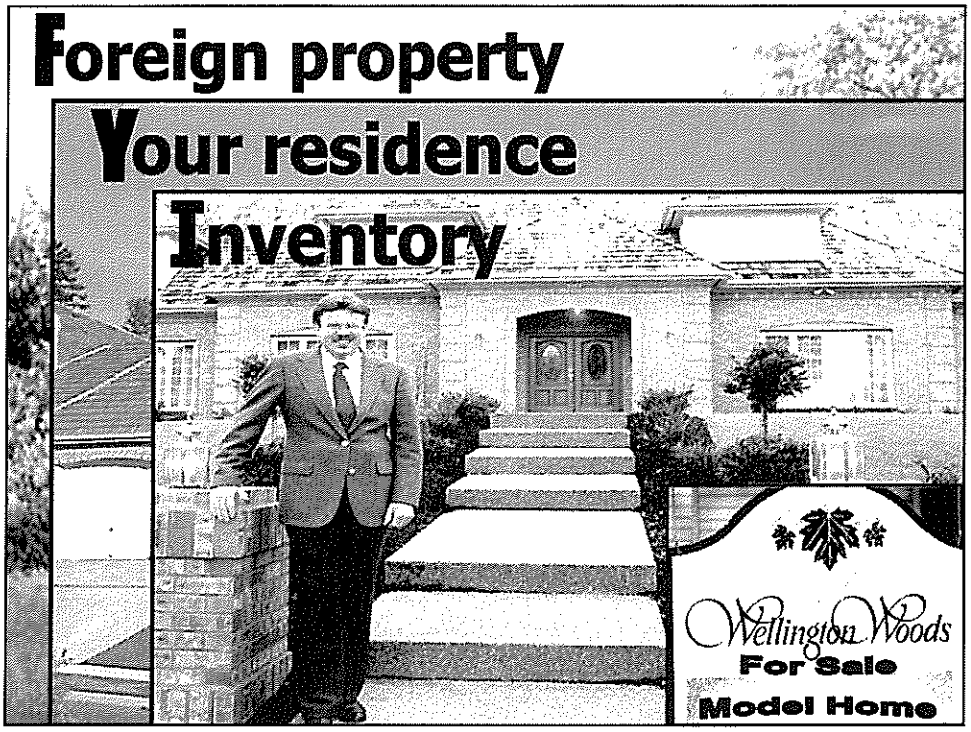
- Excluded under 1031(a)(2)
  - Interest in a partnership
  - Certificates of trust or beneficial interest, or
  - Choses in action
- Foreign property is not like kind for U.S. property under 1031(h)

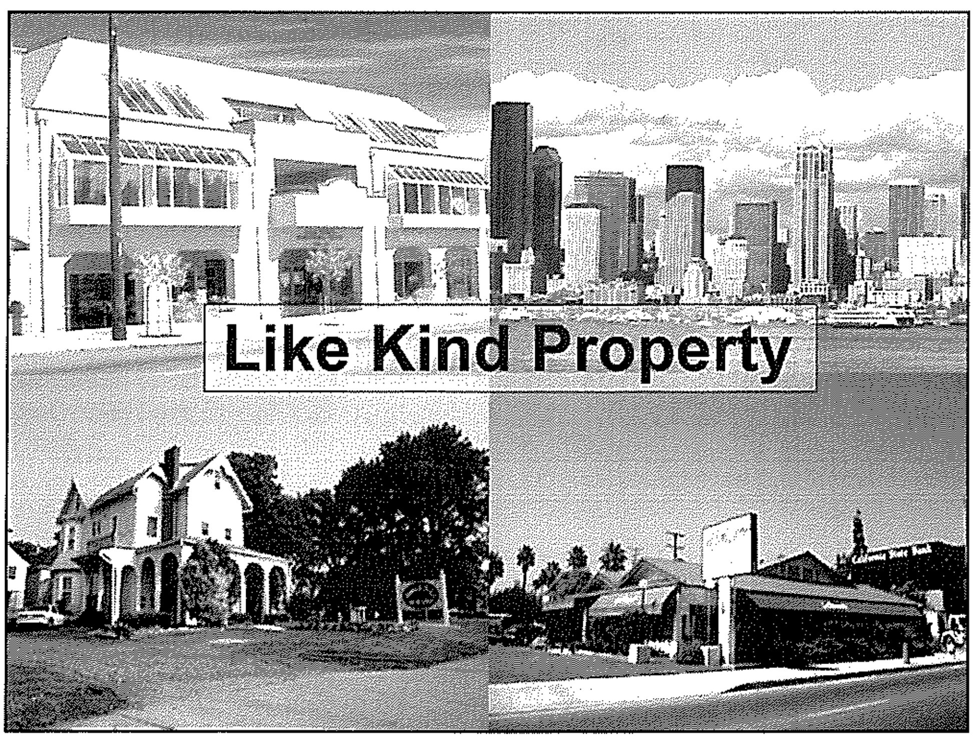
All property is like-kind

to all other property

EXCEPT

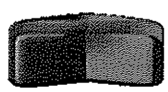
F. Y. I


Foreign property
Your residence
Inventory
Wellington Woods
For Sale
Model Home

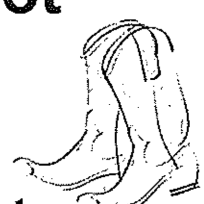

Like Kind Property

Types of "Boot"

- Cash Boot – Cash and any non-like kind property received.



Types of "Boot"



- Mortgage Boot – Mortgage boot occurs when the taxpayer is relieved of debt (or other obligations) on the relinquished property. It is sometimes referred to as *debt relief.*

Equal Value & Greater Equity

- To be a fully tax deferred exchange the replacement property must be:
  - Equal or greater in value

  AND

  - Equal or greater in equity

Equal Value & Greater Equity

	Relinquished	Replacement
Value	$ 750,000	$ 750,000
Debt	$ 450,000	$ 400,000
Equity	$ 300,000	$ 350,000

[$ 450,000 debt relief offset by
$ 400,000 new debt and
$ 50,000 cash added = NO BOOT]

Greater Value & Equal Equity

	Relinquished	Replacement
Value	$ 750,000	$ 900,000
Debt	$ 450,000	$ 600,000
Equity	$ 300,000	$ 300,000

[$ 450,000 debt relief completely offset by $ 600,000 New debt = NO BOOT]

Lower Value & Equal Equity

	Relinquished	Replacement
Value	$ 750,000	$ 500,000
Debt	$ 450,000	$ 200,000
Equity	$ 300,000	$ 300,000

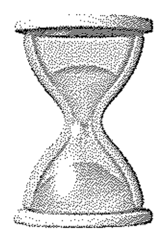
[$ 450,000 debt relief partially offset by $ 200,000 new debt, but the remaining $ 250,000 of debt relief is TAXABLE BOOT.]

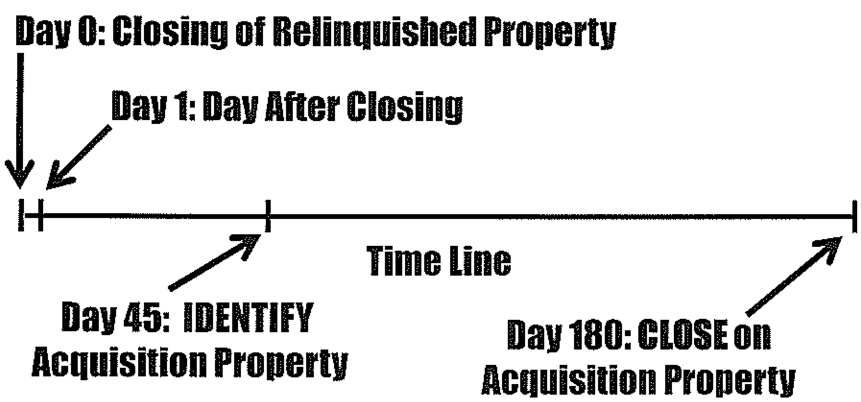
Equal Value & Lower Equity

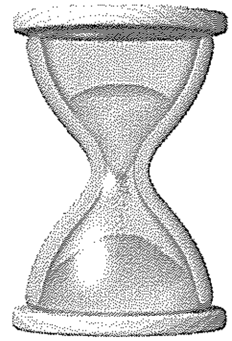
	Relinquished	Replacement
Value	$ 750,000	$ 750,000
Debt	$ 450,000	$ 550,000
Equity	$ 300,000	$ 200,000

[$ 450,000 debt relief is offset by $ 450,000 of the new debt, but the $ 100,000 cash received is not offset by the remaining $ 100,000 of new debt = $ 100,000 TAXABLE BOOT.]

TIME LIMITS for IDENTIFYING and CLOSING the ACQUISITION PROPERTY



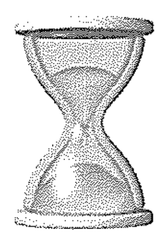




or . . .

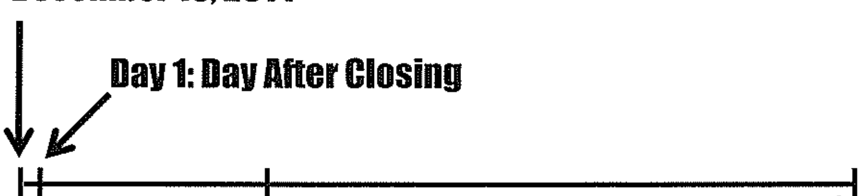
The DUE DATE of the taxpayer's tax return

. . . whichever is EARLIER



Day 0: Closing of Relinquished Property
December 15, 2014

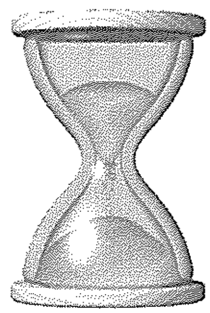
Day 1: Day After Closing



Time Line

Day 45: IDENTIFY
Acquisition Property

Day 180: CLOSE on or
before April 15, 2015
on acquisition prop.



121 DAYS !

Documenting the Exchange

Relinquished Property:

- Purchase Agreement
- Exchange Documents
  - Exchange Agreement
  - Assignment of Purchase Agreement

Documenting the Exchange

Relinquished Property:

- Closing Instructions and Settlement Statements
- Direct Deed from Taxpayer to Buyer

Documenting the Exchange

Replacement Property:

- Identification Document
- Purchase Agreement

Documenting the Exchange

Replacement Property:

- Exchange Documents
  - Assignment of Purchase Agreement
  - Notice of Assignment

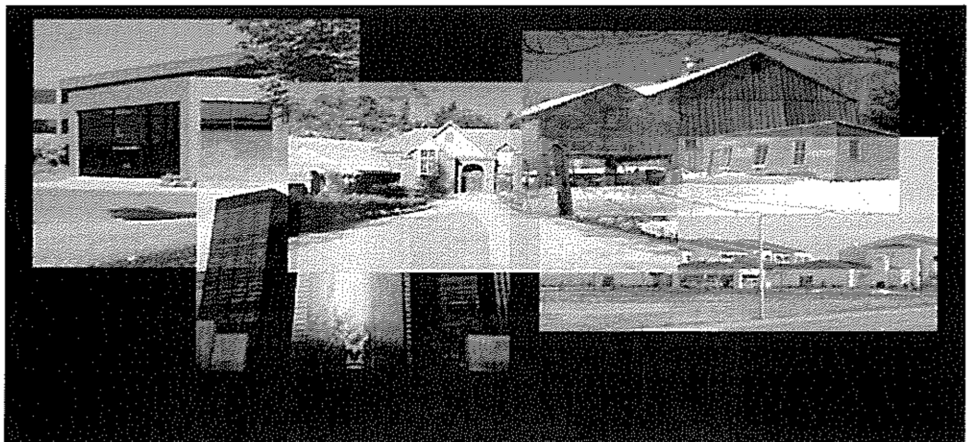
Documenting the Exchange

Replacement Property:

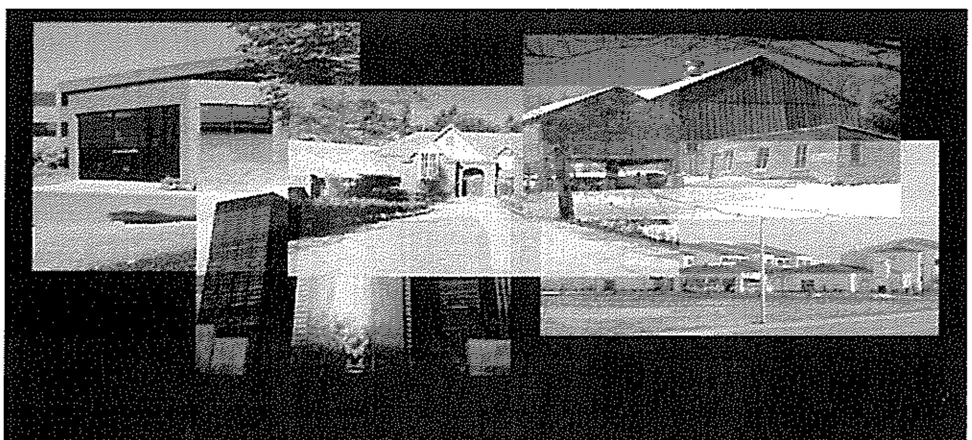
- Closing Instructions and Settlement Statements
- Direct Deed from Seller to Taxpayer within Exchange Period

Identification Methods and Requirements

Three Property Rule – Three properties without regard to the fair market value of the properties



as long as their aggregate FMV as of the end of the identification period does not exceed 200% of the aggregate FMV of all the relinquished properties as of the date the relinquished properties were transferred.



95% Rule – Identify any number of replacement properties, but you must close on at least 95% of the identified properties

Identification Requirements

- In writing
- Unambiguously identified
- Signed by the taxpayer
- Sent before midnight of the 45th day
- Revocable before the 45th day

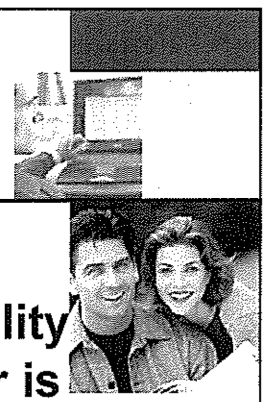
Identification of Replacement Property to Be Constructed

- Identify by legal description of land and detailed description of improvements to be made
- Improvements as built must be "substantially the same" as described
- Should be completed before taxpayer acquires replacement property

Same Taxpayer Requirement

Same taxpayer who transferred relinquished property must acquire replacement property. If not, property received is not like kind.
IRC §1031 (a)(3)

Same Taxpayer Requirement



Exceptions:

Single member limited liability company of which taxpayer is sole member

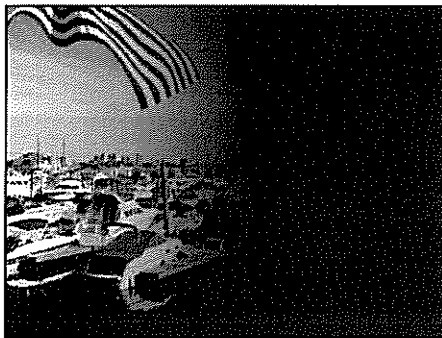
If taxpayer dies during exchange period, the taxpayer's estate or trustee may complete the exchange. Rev. Rule 64-161

Receipt of Cash

- Types of Receipt
  - Actual Receipt
  - Constructive Receipt – Control of the cash proceeds without actual receipt of the cash

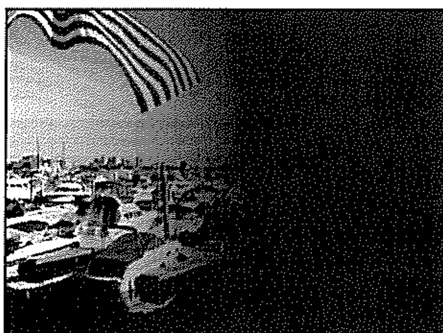
Receipt of Cash

- Effect of Receipt of Cash
  - Disqualifies the transaction from exchange treatment



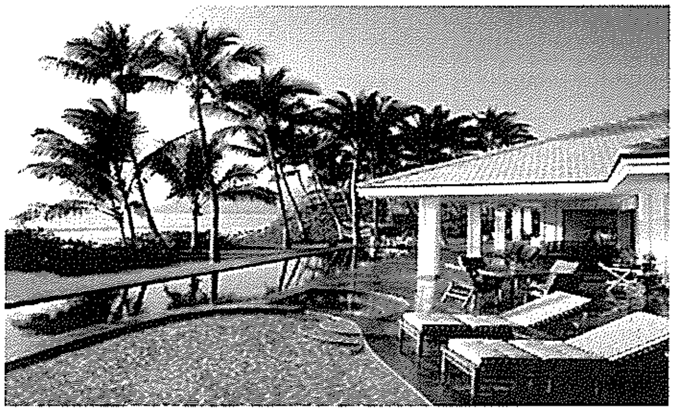
Safe Harbors from Constructive Receipt

- Security or guarantee arrangements
- Qualified escrow accounts and qualified trusts



Safe Harbors from Constructive Receipt

- Qualified intermediaries
- Interest and growth factors

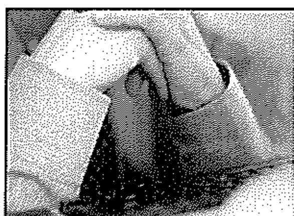


There is no definitive listing in Section 1031 of how much personal use of a property will cause it to no longer be treated as investment property

The general rule of thumb is that the taxpayer should not use the property greater than:

(1) 14 days per year; or

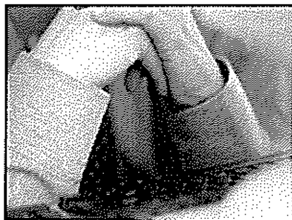
(2) 10% of the number of days at which the property is rented at a fair market rent



Selecting a Qualified Intermediary

ASK:

- Does the intermediary have a fidelity bond?
- What type of financial security is behind the intermediary?



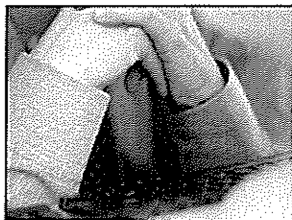
Selecting a Qualified Intermediary

ASK:

- What is the largest single transaction the intermediary has been trusted with?
- Does the intermediary have the experience to coordinate the simplest transaction to most complex transaction?

Selecting a Qualified Intermediary

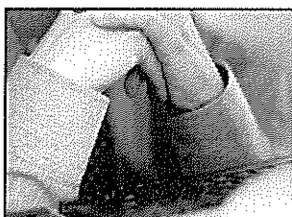
- Does the intermediary have a trusted reputation in the real estate community?
- How many corporate officers are there?
- Are the fees lower than normal? If so there is usually a reason.



Selecting a Qualified Intermediary

"Disqualified Party" is one who served the exchangor within the last 2 years as:

- Employee
- Attorney
- Accountant



Selecting a Qualified Intermediary

"Disqualified Party" is one who served the exchangor within the last 2 years as:

- Real Estate Agent or Broker
- Certain other parties related to the exchangor

Restrictions on Receiving Cash

- At the end of the 45 day "identification period" if no replacement property is identified

Restrictions on Receiving Cash

- After receipt by Exchangor of all Replacement Property to which Exchangor is entitled
- At the end of the "exchange period"

Interest

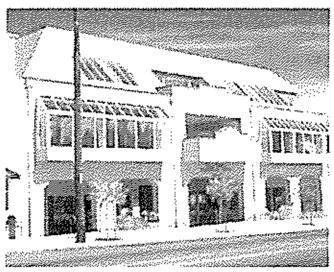
- May be earned by exchangor
- Must not be received prior to receipt of like kind property
- Is taxed

  whether received as cash, or

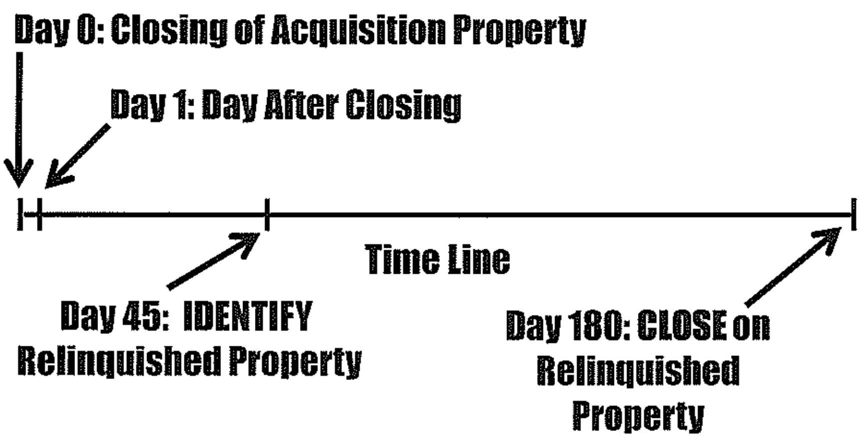
  as like kind property

REVERSE EXCHANGE RULING

REVERSE EXCHANGE RULING

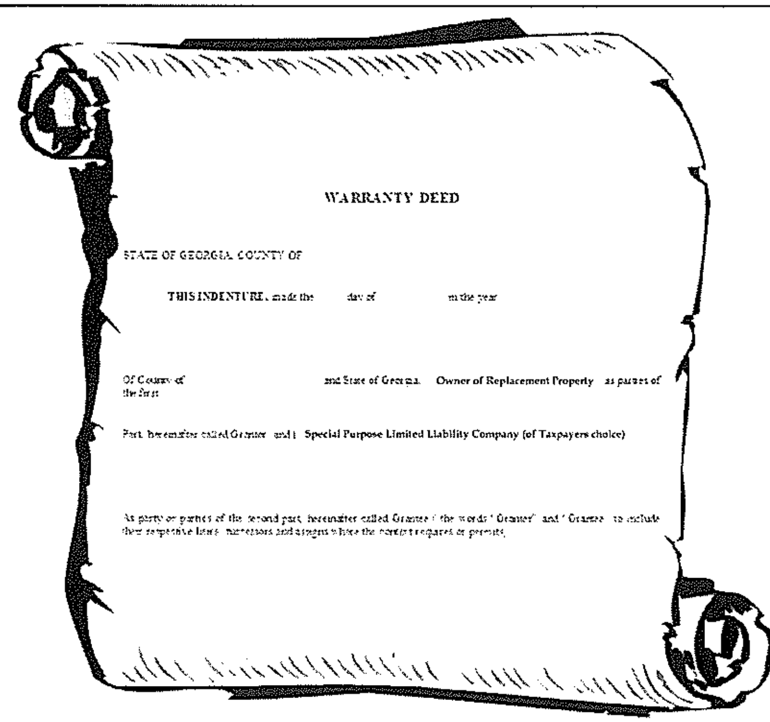


TIME LIMITS for IDENTIFYING and CLOSING the RELINQUISHED PROPERTY



Reverse Exchanges or 'Parking' Transactions

- Designed to "park" replacement property or relinquished property with an accommodating party until the taxpayer arranges for transfer of relinquished property to a buyer in a simultaneous or deferred exchange.



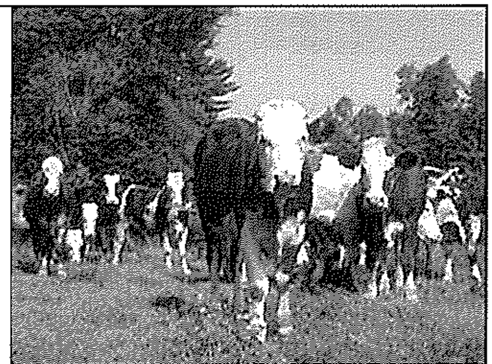
Reasons for Reverse Exchanges

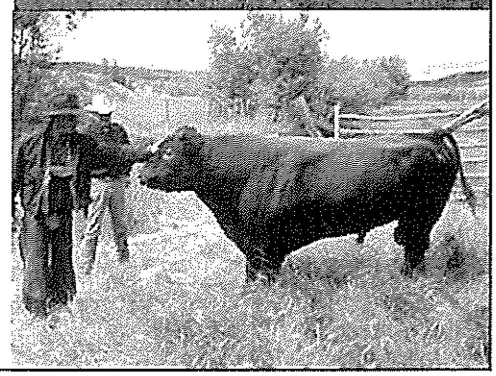
- Contingencies on relinquished property not removed in time
- No buyer for relinquished property

Reasons for Reverse Exchanges

- Prevent loss of earnest money deposit
- Prevent loss of financing commitment
- Locate replacement property first

Personal Property





- Aircraft
- Vessels
- Livestock

Personal Property

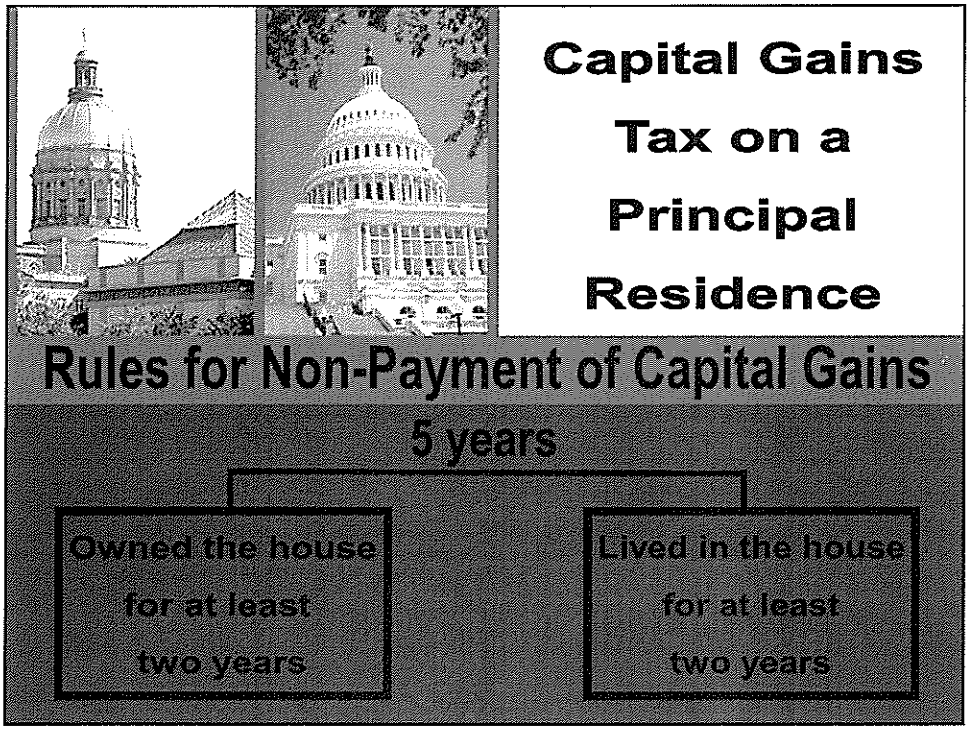
- Professional Sports Contracts
- Artworks

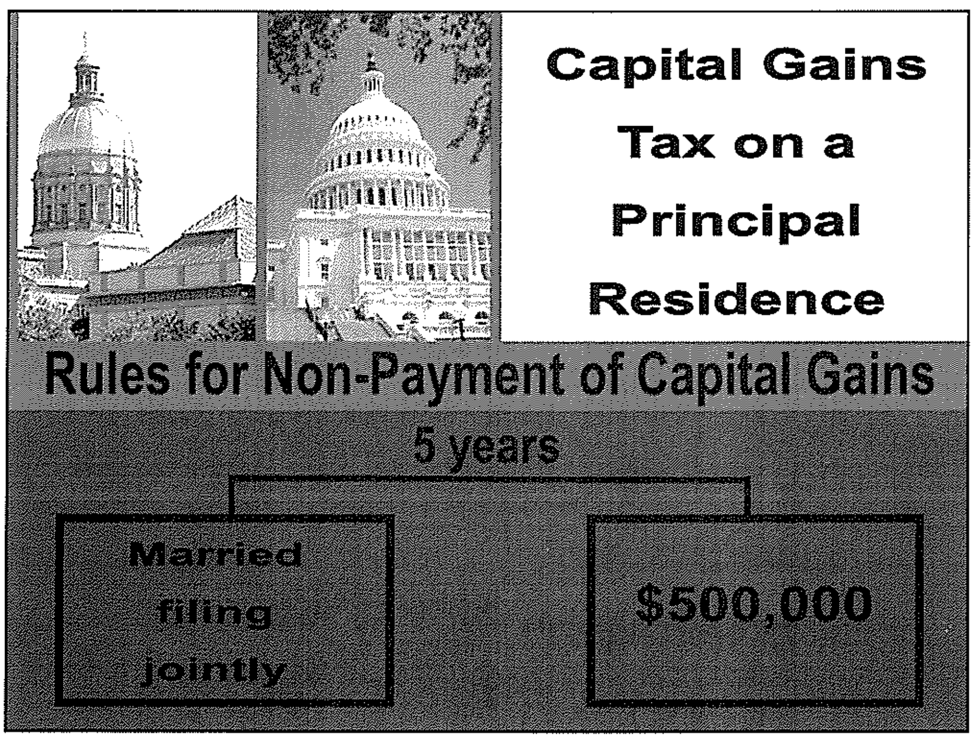
Reasons to Exchange

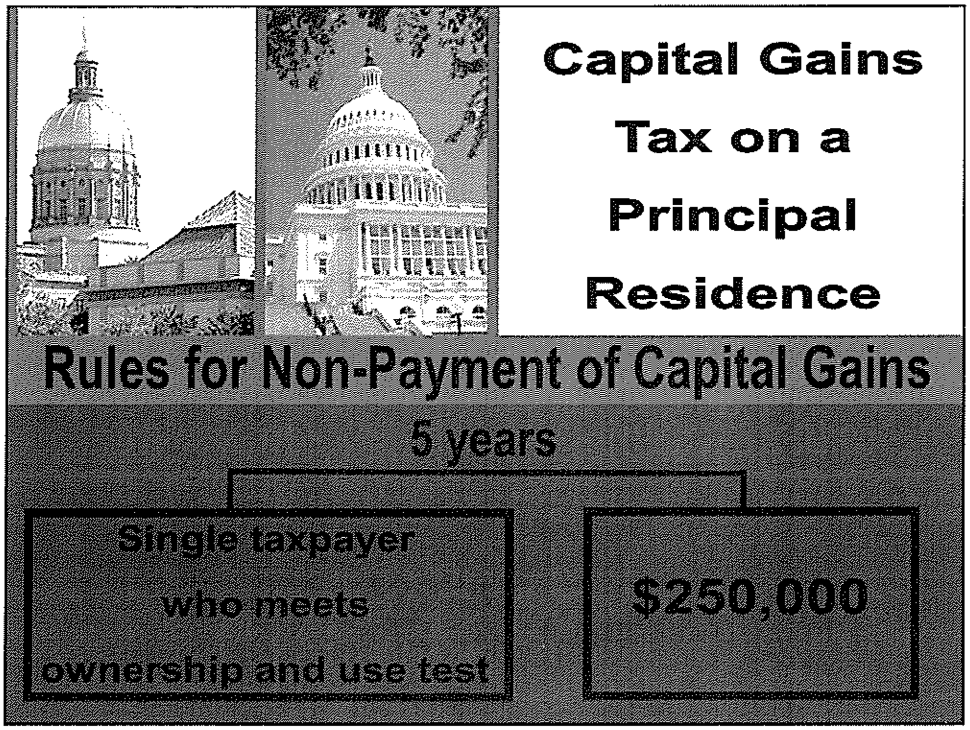
- Consolidate – several properties for one
- Diversify – one property for several
- Relocate to another geographic area
- Increase cash flow – land for improved property

Reasons to Exchange

- Eliminate property management headaches
- Eliminate a co-ownership problem
- Implement an estate plan
- Maximize leverage


Capital Gains
Tax on a
Principal
Residence
Rules for Non-Payment of Capital Gains
5 years
Owned the house
for at least
two years
Lived in the house
for at least
two years


Capital Gains
Tax on a
Principal
Residence
Rules for Non-Payment of Capital Gains
5 years
Married
filing
jointly
$500,000


Capital Gains
Tax on a
Principal
Residence
Rules for Non-Payment of Capital Gains
5 years
Single taxpayer
who meets
ownership and use test
$250,000

Brokerage Fees — Getting paid in an exchange transaction

Whenever a discussion occurs among real estate professionals about exchanging, the question usually asked first is, *How do I get paid?* The answer is, *The same way as in any other transaction.* Your are paid in accordance with your Listing Agreement or Buyers' Agency Agreement. The reason this question comes up is that many times an exchange occurs and no cash changes hands. It's important to understand that the payment of the brokerage fee is not related to the terms of sale.

There are a number of ways to collect your fee, and we will spend some time discussing the possible alternatives.

NOTE: In the discussion that follows, we will not be discussing the amount of the fee you negotiate with your client, but rather how to collect it once it has been negotiated. Your fee and the amount thereof is a matter that must remain strictly between you and your client, and is not to be discussed with any other licensee to avoid any appearance of impropriety or price fixing.

Cash — The best of all possible solutions; take your money and pay your taxes. The thing that should be pointed out here is the fact that your client should be able to pay your fee regardless of whether or not there are cash proceeds within the exchange. The amount of cash available in the exchange is usually a "problem spot" – so be sure to get your share.

Paper — In our less than perfect world, it is sometimes necessary to consider taking all or part of your fee in installments. If this should occur, there are several areas which you might be concerned about. For instance, you should secure any deferred compensation with, at the very least, a Promissory Note. And you should also consider a security interest in the property. Do not rely on a disbursement from escrow alone for payment, as there may be a default of the obligation, which might wipe out your position. Also keep in mind that the IRS will look at the fair market value of the note received as taxable upon receipt of the note. There is no provision for the installment reporting of ordinary income.

In-Kind — Some of the same considerations as above are to be considered when accepting in-kind payment of commission. The neophyte should be very aware of the underlying obligations on in-kind commissions, and consider the risk versus the reward of accepting in-kind payment.

Case Study 1

This case study is a simple two-way transaction involving a piece of vacant land and a single-family residence. Both properties have only one loan and slightly different equities. The emphasis is on the balancing of equities and dealing with differing client motivations. This case study also introduces the concept of *benefits creating value*, and orients the students' thinking toward the benefits to be derived from ownership instead of the dollar amount negotiated during acquisition.

The People and their Goals

Tom Trader, first party: A real estate investor who owns vacant land for investment purposes. The land has appreciated over a period of time, and the investor's needs have changed. Tom would like to acquire a new personal residence, and would like to use his equity in the land to do so. He is not greatly concerned about tax consequences.

Xavier X. Change, second party: A real estate investor who owns a rental house. He has owned the home for some time; the property is currently vacant. In order to rent the property, a new owner would have to do some minor repairs and advertise for a new tenant.. Like most owners of rental property, Xavier would like to have a more passive investment at times like this. Like Tom Trader, he is not overly concerned with tax consequences.

Since each type of owner derives different benefits from ownership, it's important to understand their desired benefits as they play against the differing motivation of each type. For instance, an investor is motivated by financial considerations such as return on capital, while an occupant is motivated more by physical concerns such as the number of bedrooms. This sometimes leads to a situation where the same property could have different values to different people, depending on the benefits they most desire.

Don't-Wanter Motivation

What is a don't-wanter? An owner who simply does not want to continue owning an asset. This does not mean a desire to give the property away, simply a desire not to own it any longer! Some examples are *heirs*, *lenders in possession*, *financially overburdened owners*, and *emotionally distressed owners*. Changed circumstances may play a role in creating a don't-wanter; geographic changes like a career move to another city, financial changes such as a divorce; emotional changes caused by the death of a spouse, and so on.

The Properties

Tom Trader: parcel of vacant land, Pickens County. The property is an unimproved five-acre tract of land located several miles outside the city of Atlanta. There is a small encumbrance on the land of approximately $5,400. The market value of the property is between $6,500 and 7,000 per acre. The property has been recently surveyed and has marketable title.

Xavier X. Change: rental house, 1204 Winding Road, in Atlanta. The property is an unremarkable three bedroom single-family home. The owner has an existing first Security Deed on the house; it is assumable, and has a balance of $123,900.00. The property has a market value of between $156,700 and $159,000, and the title is marketable. As mentioned before, the house is currently vacant.

Steps in the Exchange Transaction

1. *Establish the agency relationship*
    - A. Decide
    - B. Disclose
    - C. Document
    - D. Do

2. *Balance the Equities*

3. *Prepare for Closing*
    - A. Write up the Purchase and Sale Agreement and obtain signatures
    - B. Open the Escrow
        - A. Arrange for title work on both properties. Note that a second title company must be engaged to handle the "out of county" property.
        - B. Arrange for a release of Security Deed on the vacant land, and handle any requirements for assumption of the loan on the house.
        - C. Gather rental agreements, deposit information and other factors involved with the rental house.
        - D. Arrange for any required inspections.
        - E. Arrange for a survey of the vacant land parcel.
        - F. All other considerations you would have as an agent on any closing — simply multiply by 2!

4. *Close Escrow*

   Who pays what and where does the money go?

5. *Basic Overview of the Transaction*

   Tom Trader pays off the small encumbrance on the land, and then trades his $35,000 equity in the land (now free and clear) for Xavier's $35,000 equity in the home. Tom assumes the Security Deed on the home. Tom agrees to pay all costs of the transaction.

6. *Other Possible Variations of the Transaction*

   A. Tom could pay Xavier $5,400 cash at closing, and Xavier would assume and agree to pay the encumbrance on the land.

   B. Xavier could carry back a Installment Sales Contract on the house and take Tom's land subject to the encumbrance, which Xavier would then assume and agree to pay.

   C. Xavier could take Tom's land subject to the small encumbrance without assuming and agreeing to pay. This would require that Tom be responsible for the payment of the loan when due.

7. *Tax Structure*

   In this case both parties have a fully taxable transaction. They will be required to report and pay taxes on the full amount of their capital gains.

Case Study 2

This is a "classic" three-way exchange involving a single-family residence and two pieces of vacant land. We'll see how a "take-out" is arranged for an unwanted exchange property. We will emphasize the benefits of ownership, and show how any part of a transaction can be perceived as both positive and negative to the various parties involved. Then we'll see how to use these perceptions and the circumstances of the owners to create an exchange that benefits all parties.

The People and their Goals

Connie Minium, first party: A homeowner who lives outside of town and commutes to work daily. She has owned the home for some time and would like to use her equity to buy a lot closer to town and build a new, larger home on it. Connie is faced with certain dilemmas –

1. Since her home is so far out of town, it might be hard to achieve a sale in an acceptable period of time.
2. If a sale does occur, where will she live during the construction of her new home?
3. If her home sells, what happens if she can't find an acceptable lot to build a new home on?

Woody Hillsburg, second party: A real estate investor who owns vacant land for investment purposes. Woody has held the land for some time, and it has appreciated. He would like to "take his profits" and acquire a rental property as a tax shelter; but he has a very low basis in the land and must consider the tax ramifications of any transaction.

Sue M. Sellers, third party: A real estate investor who owns vacant land for investment purposes. She has held the land for some time, and it has appreciated well. She would like to lock in her profit and acquire a new investment vehicle. Sue is not interested in rental property and must be very careful about the tax implications of a potential transaction.

The Properties

Connie Minium: personal residence, Bartow County near Cartersville. The property is a single-family home on five acres of land in a mostly agricultural area. Connie has an encumbrance on the home of approximately $110,000; it is a first Security Deed, assumable if the buyer qualifies with the lender. The market value of the property is between $146,500 and $150,000. It has been recently surveyed and has marketable title. There are a couple of complications, however —

1. The loan on the property is a consideration in any transaction — its assumability, loan terms, remaining balance, etc.

Woody Hillsburg: parcel of vacant land, Tall Pines Road in Cherokee County. This is a nine-acre parcel of unimproved land, not subdivided. Located in a wooded, mountainous area, it has potential as a vacation homesite or rural retreat. It is free and clear, with a market value of between $36,500 and $40,000. It has marketable title.

Sue M. Sellers: parcel of vacant land, is in Cobb county. The property consists of 2.5 acres of unimproved land adjacent to Sue's residence. The property has been surveyed in the past as a separate lot. The market value is between $36,500 and $40,000, and it has marketable title. Two complicating factors exist, however. Over the years, fences and markers have been displaced or removed, so the property would have to be re-surveyed. And the land is subject to a blanket encumbrance with Sue's residence, in an amount of approximately $54,000, which is substantially in excess of the land's market value.

Structuring the Transaction

Connie Minium would like to acquire Sue M. Seller's vacant lot to build on, but Sue is not interested in exchanging for Connie's house as a rental property. However, Sue is interested in acquiring a larger parcel of vacant land, and Woody Hillsburg's nine acres would work for her. As it happens, Woody is interested in acquiring a rental property that he could depreciate, and Connie's Cartersville house would meet that need.

Steps required for closing the deal

1. ***Prepare the Purchase and Sale Agreements***
    A. Connie Minium and Woody Hillsburg (house and 9 acres)
    B. Connie Minium and Sue M. Sellers (9 acres and 2.5 acre lot)

2. ***Remove contingencies***

3. ***Prepare for Closing***
    A. Open the Escrow; Escrow Considerations
        a. Arrange for title work on all properties;
        find a title company to handle the "out of county" properties.
        b. Prepare a rental agreement between Connie and Woody to cover the period when Connie's new home is under construction.
        c. Arrange survey of Sue's land to re-establish lot lines.
    B. Security Deed Assumption considerations.
    C. Obtain release of Sue's vacant land from the master Security Deed.
    D. New home financing and construction considerations; problems.

4. *Close Escrow*

Who pays what and where does the money go?

5. *A simplified overview of the transaction*

Connie Minium trades her home near Cartersville for Woody Hillsburg's nine-acre parcel of land. Woody qualified for the assumption of the existing security deed on the house . Connie then trades the nine acres to Sue Sellers for the 2.5-acre lot on which to build her new home. During the construction of the new home, Connie agrees to rent back her current home from Woody Hillsburg on a "net-net" basis, thereby eliminating the need for Woody to find a tenant immediately.

6. *Tax Structure*

In this particular transaction, all parties are able to defer any gain realized!

Connie Minium excludes her realized gain on the home since it has been her principal residence for more than two years. And both Sue Sellers and Woody Hillsburg are able to defer their gain under Section 1031 of the Internal Revenue Code, which allows for non-recognition of gain when exchanging like-kind property under the right circumstances.

7. *Other Possible Variations of the Transaction*

A. Woody Hillsburg could have kept his land, and purchased Sue M. Seller's land to trade to Connie Minium for her house. This could have been a cash purchase, or Woody could have purchased the land by giving Sue a second mortgage secured by Connie's home. This technique would also be an option for Connie, providing there was no problem with her making double mortgage payments.

B. Sue could have traded for Connie's house in a direct transaction, or could have tried to find another "take out" for the house.

Case Study 3

This case study involves an exchange of multiple properties in different venues. We will study the steps required to complete a transaction when there are multiple compliance problems caused by differing legal and title requirements from state to state or county to county. Emphasis will be placed on the balancing of equities, the simplicity of the concept and the multiplication of efforts required when making multiple property transfers.

The People and their Goals

E.T. Barter Corp., first party: An established and knowledgeable real estate investment and property management firm, wholly owned by Mr. E.T. Barter. The company has acquired several investment properties over the years. These are located in different parts of the country, and the company has experienced management difficulties due to their scattered locations. E.T. has decided that he would like to consolidate his holdings into one easier-to-manage investment in the town where he lives.

Darth Trader, second party: A well-to-do businessman, Mr. Trader has moved into a small condominium and is having trouble selling his high-priced former residence. He is under no particular pressure to sell, although he is uncomfortable with the property sitting vacant for an extended period of time. The property is free and clear. He would be interested in an investment of some sort after he sells the home.

The Properties

E.T. Barter Corp.: three properties available —

1. Single-family residence: 1001 Pothole Place. A starter home or rental house. Has an existing FHA first mortgage with a balance of approximately $101,000. Located in a desirable area, and should be easily marketed. E.T. has owned the home for some time and has a very low basis in the property, so a sale could generate a large tax liability. The market value is $154,000.

2. Vacant lot: Gator Gully Addition, Yuk, Florida. Might best be referred to as "currency" land — its worth is in the fact that it has an identifiable value (like money?), not in the fact that it is readily salable. E.T. acquired the lot years ago through a promotional offer on a new development; it is simply excess inventory to him at this point. The market value is set at $56,000.

3. Acreage: Socorro County, NM. Irrigated acreage which Barter Corp. leases out on an annual basis for alfalfa production. The land has a very identifiable value and is producing a steady income. The property is free and clear, so the only expenses Barter Corp. has are real estate and water use taxes. The market value is $203,400.

The Properties (cont'd.)

Darth Trader: personal residence, 8500 Diamond Drive. A "high-end" home located in a very desirable neighborhood; if the market were not so soft, it would probably sell quickly for cash. Trader is faced with either reducing the price drastically to achieve a quicker sale, or taking a small down payment and carrying a installment sales contract for the balance; neither option appeals to him. The market value of the property is $312,400.

With the properties described, would an exchange create a taxable event for E.T. Barter Corp.? Why or why not?

Would it create a taxable event for Darth Trader? Again, why or why not?