

1031 Exchange: Advanced Strategies

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What is an Accommodator?



Holds all sale proceeds



Prepares all required legal documentation



Insures compliance with IRC Code Sec 1031



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Asset Exchange Company (est. 2006)



Errors and Omissions Insurance and
Fidelity Bond



Member of the CA Board of Accountancy



Member of the State Bar of California



Free Audit Support



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THE UNITED STATES ATTORNEY'S OFFICE
NORTHERN DISTRICT *of* CALIFORNIA

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NEWS



Salinas Realtor Sentence To 14 Months Imprisonment For Tax Evasion

FOR IMMEDIATE RELEASE

May 13, 2013

SAN JOSE, California – Cheryl Savage was sentenced last week to 14 months in prison, and ordered to pay a \$10,000 fine and \$123,463 in restitution for tax evasion, United States Attorney Melinda Haag and Internal Revenue Service, Criminal Investigation, Special Agent in José M. Martinez announced.

Savage, age 57, of Monterey, California, pleaded guilty on September 12, 2012. According to court documents, Savage has been a realtor since 1981, becoming a broker in 1988 when she opened Steinbeck ERA Realty, a real estate brokerage in Salinas, California. On her business website, Savage describes herself as knowledgeable in 1031 Tax Deferred Exchanges. A 1031 Tax Deferred Exchange occurs when a taxpayer sells rental property and reinvests the sales proceeds in replacement rental property. In this way, a taxpayer can defer the recognition of capital gains tax until the replacement rental property is sold.

In 2004 Savage sold two rental properties, realizing \$777,014 taxable gain. Savage used those sales proceeds to purchase her primary residence at Via Del Milagro in Monterey, California. In October 2005, she filed her 2004 federal income tax return falsely reporting that the proceeds from the sale of her rental properties were used to purchase a replacement rental property. Savage also falsely reported that she had received rental income from Via Del Milagro. The rental payments Savage reported on Schedule E of her



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Galaxy Office Park, Concord CA

- \$42,000,000 Sale Price
- 3 LLC owners, with multiple LLC members
- No replacement property lined up



Sandy Springs Apartments, Atlanta GA

- \$26,000,000 Sale Price
- 27 individual TIC owners
- Each individual owner conducting separate exchange



Armory Building, San Francisco CA

- \$65,000,000 Sale Price
- 1 LLC owner
- 30 Replacement Properties



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Why Investors Exchange:

Tax Deferral

- 1/3 of total gain goes to pay taxes.

Buy “MORE” Property

- Utilize “saved/deferred taxes” to leverage into a larger property.
- Exchange from a property that has a high equity position into a much more valuable property.

Diversification

- Geographic diversification.
- Asset class diversification.

Longtime Ownership Issues

- Relief of management burden.
- Exchange from a fully depreciated property to a higher value property that can be depreciated.



Tax Rates & Changes

Federal Taxes

<input type="checkbox"/> Federal Capital Gains Tax:	15%
<i>Income >\$400K/\$450K</i>	20%
<input type="checkbox"/> Depreciation Recapture:	25%
<input type="checkbox"/> Medicare Tax:	3.8%

- Income calculations include ordinary income and capital gain income
- In 2013, 3.8% Medicare tax on all income from interest, dividends, annuities, royalties, **capital gains** and rents for individuals who earn more than \$200,000 annually and joint filers reporting more than \$250,000.



California State Tax Changes

State Taxes

California passed **Proposition 30** which raises tax rates considerably. Taxes at the state level for many Californians are still at or below 9.3%, but for married couples with income over \$500K, the rates are as follow:

<u>Rate</u>	<u>On Income</u>
10.3%	\$500K-\$600K
11.3%	\$600K-\$1M
12.3%	\$1M++



Gain Calculation

Gain Calculation:

Sale Price	\$1,000,000
(Adjusted Basis)	(\$425,000)
Gain	\$575,000

Adjusted Basis:

Purchase Price	\$500,000
(Depreciation)	\$100,000
+Capital Improvements	\$25,000
Adjusted Basis	\$425,000

Facts:

\$500,000 purchase price
\$100,000 depreciation
\$25,000 capital improvements
\$1,000,000 sales price

Taxes:

25% Dep. Recapture

$$\$100,000 \times 25\% = \$25,000$$

20% Fed. Cap Gains

$$\$475,000 \times 20\% = \$95,000$$

3.8% Medicare Tax

$$\$475,000 \times 3.8\% = \$18,050$$

9.3% State Cap Gains

$$\$500,000 \times 9.3\% = \$46,500$$

10.3% State Cap Gains

$$\$75,000 \times 10.3\% = \$7,725$$

Total Taxes Due:	\$192,275
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Tax Advantages - Selling

IRC Section 1031?

- **Investment** Real Estate
- Tax **Deferral**

IRC Section 121?

- **Primary** Residence
- Tax **Avoidance**
 - \$250K single
 - \$500K married



1031 Guidelines

Basic Requirements:

- ✓ Property Qualifications
- ✓ Tax Deferral Requirements
- ✓ Timeline
- ✓ Identification Rules



Guideline #1

Property Qualifications

- ✓ Held for productive use in trade or business or for investment.
- ✓ Like kind
 - Foreign property is NOT like kind
 - Quick Flips are NOT like kind



Guideline #2

Tax Deferral Requirements

- ✓ Reinvest all cash.
- ✓ Purchase price equal or greater in value.



Guideline #3

Timeline

- 180 days
- 45 day identification period.

Day 0

Close of
Escrow

Day 45

Identification
Letter Due

Day 180

Exchange
Completed



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Guideline #4

Identification

- ✓ 3 Property Rule
- ✓ 200% Rule



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Guideline #4

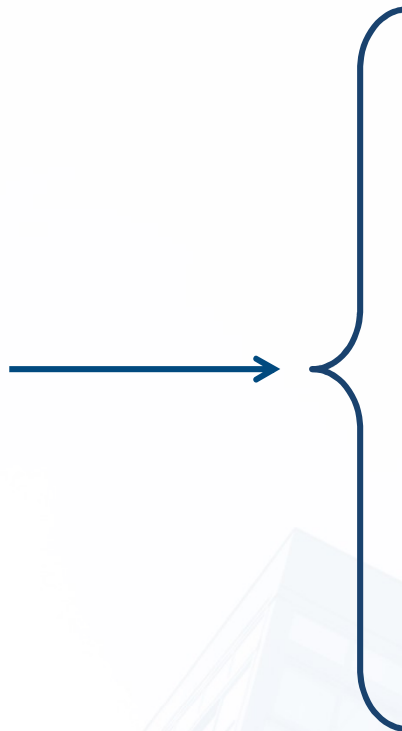
3 Property Rule



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Guideline #4

200% Property Rule



200%



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1031 Guidelines

Basic Requirements

- ✓ Property Qualifications
- ✓ Tax Deferral Requirements
- ✓ Timeline
- ✓ Identification Rules



Opportunity Zones

- ✓ There are over 8700 Opportunity Zones representing about 12% of US census tracts.
- ✓ The average poverty rate in the zones is 32 percent, compared with the national average of 17 percent.
- ✓ Investment in an opportunity zone is done thru an “Opportunity Fund”.
- ✓ The taxpayer can sell any type of asset with capital gains and must invest the gains into the fund within 180 days. Real estate gains as well as stock gains or gains from the sale of a business would qualify.
- ✓ The Fund must have 90% of it's assets invested in Opportunity Zones.



Opportunity Zones

- ✓ The original capital gains taxes are deferred until the OPZ investment is sold or 12/31/2026, whichever is earlier.
- ✓ If the investment is held for 5 years, the original capital gains are given a 10% reduction in the amount of taxes owed.
- ✓ If the investment is held for 7 years, the original capital gains are given a 10% reduction in the amount of taxes owed.
- ✓ New ins earned by the QOZ investment may be excluded from taxes if the investment is held for 10 years.



Opportunity Zones

- ✓ **Substantial improvements to the property must be done within 30 months of acquisition.**
 - ✓ **The investor must double their basis, excluding land.**
- Treasury Department to issue further clarification
- No deferral of CA taxes



Using 121 & 1031 Together

Rental to Primary – Conversion Post 2009

\$100K



\$600K



Rental 2 Years (NQ)

Primary 2 Years

2012

- Purchase property for \$100K
- Use property as rental
- Now worth \$600K

Tax Implication: \$83,000

- 1/2 of Gain Exempt (\$250K)
- 1/2 of Gain taxed (\$250K)
- Taxes approx. \$83K

2014

Convert to Primary

2016

Sell Property for \$600K

Facts:

- **2 Years of “Non Qualified” Gain**
- 2 Years as Primary
- Eligible for Homeowners Exemption
- 1/2 of Gain allocated to “Non Qualified” Rental Period



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Using 121 & 1031 Together

Primary Residence to Rental:

\$100K



\$1MM



Primary 20+ years

Rental 2 years

1991

- Acquire Primary \$100K
- Property now worth \$1MM
- Gain of \$900K
 - \$500K of gain tax exempt
 - \$400K of gain taxable = **\$100K in taxes**

2012

Convert to Rental

2014

Sell Property for \$1MM

Tax Implication: \$0.00



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Reverse Exchange

(sold)



(purchased)



(purchase)



(sell)



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Reverse Exchange

Why do a Reverse Exchange?

- Seize the Moment – the buy of a lifetime
- Insurance Policy – Overheated market, protect your exchange (insurance policy)
- Poor Planning – My property isn't selling when I thought it should and I've already made an offer



Reverse Exchange

Buy first, then sell

Replacement



- EAT warehouses the “replacement property”
- Client operates property under a NNN lease agreement
- Client takes title when relinquished property sells

Relinquished



- Relinquished property must sell within 180 days
- Property sells, taxes deferred
- Property does not sell, client owns 2 properties



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Construction Exchanges

Use 1031 Exchange Funds to improve or build a property



- Relinquished property sells
- Funds sent to Accommodator

- EAT warehouses the “replacement property”
- Accommodator holds remaining funds

- Accommodator disburses all funds to contractors
- Client manages all construction

- EAT transfers new/improved property to client



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Advanced Issues – Blended Exchange

Reverse Exchange: Buy first, then sell

Forward Exchange: Sell first, then buy

Example: Sale, Purchase, Sale



Sell Relinquished #1



Buy Replacement



Sell Relinquished #2



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Advanced Issues – Blended Exchange

Reverse Exchange: Buy first, then sell

Forward Exchange: Sell first, then buy

Sell Relinquished #1 → Buy Replacement → Sell Relinquished #2



Purchase Closes
Reverse: Day 0

Reverse: Day 45
ID Letter: Identify
property to sell

Reverse: Day 180
Sale #2 must be completed
Title transferred back to exchangor

Day 0
Forward: Day 0
Sale #1 Closes

Day 45
Forward: Day 45
ID Letter: Identify
property to buy

Purchase Closes
Reverse: Day 0

- Sale #1 proceeds used toward purchase
- Exchange Company takes title to replacement while Sale #2 is in progress

Day 180
Forward: Day 180

- Replacement purchase must be completed
- All Sale #1 proceeds applied



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Advanced Issues – Multi-Family

Rental (50%)

Primary Residence
(50%)



Example:

- Live in upper unit
- Rent out lower unit

Sale price: 600k

50% rental

50% primary residence

**Exchange value: 300k
(investment portion)**



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Advanced Issues – Multi-Family



Sale Property:

- \$1M
- 100% Investment



Replacement Property:

- \$2M
- 2 Units
- 50% of the property can be lived in (1 unit rented, one used for primary residence)



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Advanced Issues – Multi-Family



Sale Property:

- \$1M
- 100% Investment



Replacement Property:

- \$4M
- 25% of the property needs to be used as an investment
- 75% can be used as primary residence



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Swap Until You Drop



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No Appreciation Exchanges

Example

Facts:

- \$1,000,000 purchase price
- \$1,000,000 sales price

Problem:

- \$200,000 depreciation
- Depreciation lowers basis

Tax Liability:

- 25% Depreciation Recapture Tax
- \$50,000 federal depreciation tax bill
- \$20,000 state capital tax



Seller Financing

Seller Financing and 1031 Exchanges:

1. Do NOT include the Note in the exchange and pay any taxes.
2. Include the Note in the exchange by showing the “Asset Exchange Company” as the Beneficiary and possibly defer the capital gain taxes.

Option #2: Asset Exchange Company as the note beneficiary:

- Use the Note Towards the Down Payment on the Replacement Property
- Exchanger Purchases Note From the Exchange Company
- The Payer on the Note Pays Off the Note Prior to Closing on the Replacement Property
- Sell the Note on the Secondary Market



Shameless Plug

- **We want your 1031 Exchange business.**
- **If you feel we do a good job today, that is the exact same impression we will give your clients.**
- **We are interested in building lifelong clients.**
- **We will make you look good.**
- **Nobody knows 1031 Exchange better than us.**



Audits

January 6, 2012 8:33 AM

IRS says audit rates have grown for the wealthy

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(AP) WASHINGTON - If you earn less than \$200,000 a year, there's a strong chance you don't have to worry about an Internal Revenue Service audit. But if you make more than \$1 million annually, the odds have been rising that you'll be hearing from the tax man.

The IRS released figures Thursday showing that 12 percent of millionaire earners were audited last year. That's up from 8 percent in 2010 and 6 percent in 2009.

The data shows that for those making under \$200,000, the rate has stayed steady at around 1 percent in recent

years.

IRS officials said the growing audit rate for high earners is aimed at demonstrating that the tax code is being enforced fairly and is unrelated to President Barack Obama's recent proposals to boost taxes on the rich. The White House and congressional Democrats are expected to continue taking similar populist stances with the approach of this November's presidential and congressional elections.



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Contact Info

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