



1031 Exchange: Pitfalls and Problems!

Presented by:

Leonard Spoto
Asset Exchange Company, LLC



1031 Exchange

1031

IRC Section 1031?

- Investment Real Estate
- Tax Deferral

"No gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment, if such property is exchanged solely for property of like-kind which is to be held either for productive use in a trade or business or for investment."

Asset Exchange Company

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Member of the Federation of Exchange Accommodators



Errors and Omissions Insurance and Fidelity Bond through Lockton Insurance Brokers

Department of Consumer Affairs
California Board of Accountancy

Member of the CA Board of Accountancy



Member of the State Bar of California

Free Audit Support

Problem: Too Late!

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Facts:

- **Client opens escrow on \$700K rental property**
- **Client instructed Escrow of intent to 1031**
- **Client assumed Escrow set up 1031 Exchange account**
- **Escrow closed Friday**
 - **Deed recorded**
 - **Funds disbursed to client**
- **No Exchange account was set up**
- **Client owes taxes!!**

Improper Use/Tax Fraud

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- Sold Rental
- Bought SFR
- Moved into SFR
- Falsified Tax Returns

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

Related Parties

Common Related Parties

- Members of the same family unit (siblings, spouse, ancestors, and lineal descendants)
- Corporation where more than 50% of the value of the stock is owned directly or indirectly by or for one particular individual;

Part II Related Party Exchange Information

8	Name of related party	Relationship to you	Related party's identifying number
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Address (no., street, and apt., room, or suite no., city or town, state, and ZIP code)

9 During this tax year (and before the date that is 2 years after the last transfer of property that was part of the exchange), did the related party sell or dispose of any part of the like-kind property received from you (or an intermediary) in the exchange? Yes No

10 During this tax year (and before the date that is 2 years after the last transfer of property that was part of the exchange), did you sell or dispose of any part of the like-kind property you received? Yes No

If both lines 9 and 10 are "No" and this is the year of the exchange, go to Part III. If both lines 9 and 10 are "No" and this is not the year of the exchange, stop here. If either line 9 or line 10 is "Yes," complete Part III and report on this year's tax return the deferred gain or (loss) from line 24 unless one of the exceptions on line 11 applies.

11 If one of the exceptions below applies to the disposition, check the applicable box:

Related Parties

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Related Party Rules

- Can only buy from a related party if that person is doing a 1031 Exchange
- Can only sell to a related party if that person holds the property for two years

Same Taxpayer Requirement

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Requirement:

Taxpayer who sells must be the same taxpayer who buys!

Issues/Problems:

- Woman acquires property when single, later marries. Sells the property and exchanges.
- Trust established. Grantors (parents) die, beneficiaries never change title, trust reverts to irrevocable trust
- LLC owns property, members want to split up and exchange separately.
- Adding brother/sister/partner to title prior to sale

Boot!

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Facts

<input type="checkbox"/> Sale Price	\$500K
Equity	\$300K
<input type="checkbox"/> Replacement Purchase	\$500K
20% Down Payment	\$100K
Debt	\$400K

Excess Taxable Cash:	\$200K
Tax liability:	\$66K

P.S. – I've seen mortgage brokers screw things up because they don't know how much cash is going to be the down payment!

Boot!

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Facts

<input type="checkbox"/> Sale Price	\$500K
Equity	\$300K
<input type="checkbox"/> Replacement Purchase	\$300K
Debt	\$0

Excess Taxable Cash:	\$200K
Tax liability:	\$66K

Boot!

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Facts

<input type="checkbox"/> Sale Price		\$500K
Equity		\$300K
<input type="checkbox"/> Replacement Purchase		\$475K
Equity		\$300K
Debt		\$175K
Debt Relief	:	\$25K
Tax liability:		\$8K

Boot – Closing Costs

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Non Recurring Closing Costs

- Sales commissions
- Title and escrow fees
- Recording fees
- Transfer Taxes
- 1031 Exchange Intermediary fees

Recurring Costs and Loan Costs

Mortgage interest

Mortgage prepayment penalties

All prorated expenses including property taxes, utilities, homeowner's fees and insurance expenses

Reserves

Boot – Closing Costs

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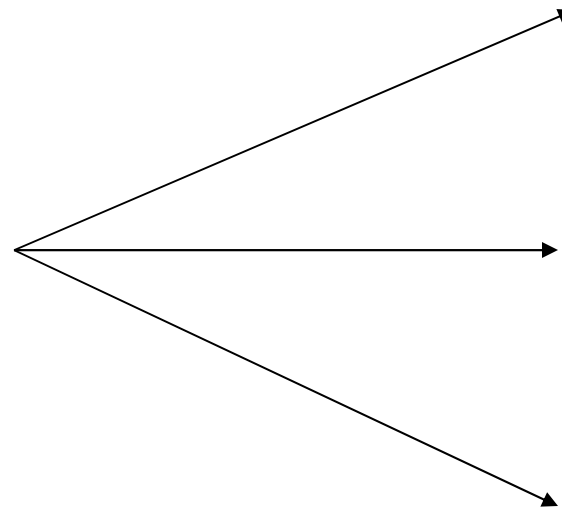
Costs to prepare the property for sale

- New Paint
- New Carpet
- Sewer
- Staging
- Fixing the deck

ID Nightmares

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➤ **\$1M Sale**



➤ **\$250K**



➤ **\$250K**

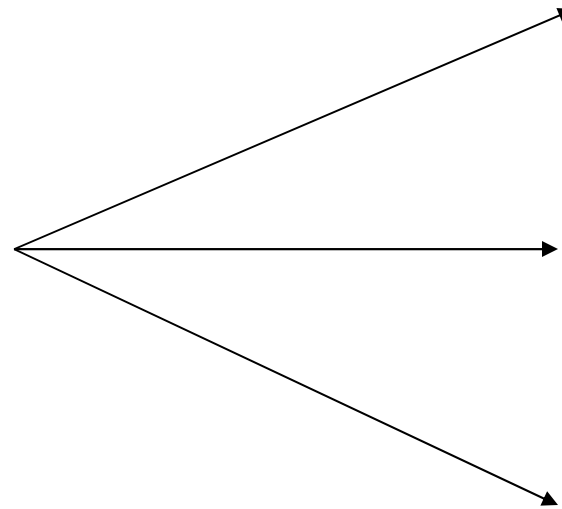


➤ **\$250K**

ID Nightmares

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➤ **\$1M Sale**



➤ **\$1M**



➤ **\$1M**



➤ **\$1M**

Air BnB, VBRO, etc.

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Revenue Procedure 2008-16

- The property was owned for at least 2 years prior to the sale and it was also rented, for fair market rent, for at least 14 days or more during the 2 years prior to the sale.
- Personal use of the property by the owner was limited to the greater of 14 days per year during each of the 2 years prior to the sale or 10% of the number of days the property was actually rented out.

Short Sales, Foreclosures

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- Short Sale
 - require lender approval
 - May not close in time

- Foreclosures
 - Constructive receipt of funds?

- New development
 - May not close in time

Foreign Sellers

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15% FIRPTA

- a. A withholding certificate issued by the IRS that sanctions the particular exchange and allows the transferee to avoid withholding tax or,
- b. Notice from the foreign seller that certifies that the seller has applied for a withholding certificate (Form 8288-B)
- To apply for a withholding certificate, the foreign seller must have an individual taxpayer identification number. The application for an ITIN is done with IRS form W-7 and can take four to six weeks to be processed by the IRS.

Seller Financing

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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

No Appreciation Exchanges

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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

Other Chaos

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- EO accidentally sent 1/2 funds to clients account
- Seller/ Exchangor dies during 1031 Exchange
- Natural disaster (Hurricane/fire) during 1031 Exchange
- One party to the exchange out of the country during the process

Shameless Plug

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- **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

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January 6, 2012 8:33 AM

PRINT  TEXT 

IRS says audit rates have grown for the wealthy

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(iStockphoto)

(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.

Contact Info

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Asset Exchange Company

Contact: Leonard Spoto
Toll Free: 877.471.1031
Fax: 877.480.1031
Email: leonard@ax1031.com
Web: www.ax1031.com

