

# 1031 Exchange: Problems & Pitfalls

Presented by:



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**Asset Exchange Company**

# Housekeeping



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Questions are encouraged!

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Presentation material will be emailed

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We want to earn your business and referrals

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# 1031 Exchange

## IRC Section 1031

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

Internal Revenue Code Section 1031 is one of the single greatest wealth building tools available to the real estate investor.



# Most Common 1031 Problem

## 1031 Exchange Problem:

- Unable to find suitable replacement property



# Problem: Too Late!

## 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

## Facts

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

## Salinas Realtor Sentence to 14 Months Imprisonment for Tax Evasion

Monday, May 13, 2013

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**For Immediate Release**

U.S. Attorney's Office, Northern District of California

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 2004 federal income tax return were actually from a tenant who leased another property Savage owned.

Savage was charged by a federal grand jury on October 4, 2011 with three counts of tax evasion. She pleaded guilty to one count.

TOP



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# Related Party Issues

## 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

<b>8</b>	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 Party Issues

## 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





# Helping the Kids Buy a Home

Buying replacement property in a 1031 Exchange with a partner? Be sure to:

1. Acquire replacement property as tenants in common with a TIC agreement that outlines terms of ownership.
2. Acquire a percentage of the replacement property that satisfies your exchange requirement.
3. Allocate the burdens and benefits according to the percentage of ownership.
4. Use your portion of the property for business or investment purposes.
5. Collect rent from kids!



# Vacation Properties



## Revenue Procedure 2008-16:

1. 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.
2. 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.



# Improvements prior to a 1031 Exchange



Funds invested into a property for repairs are classified as either “capital improvements” or “expenses”.

- Capital improvements increase the basis in the property.
- Expenses are written off against rental income.

Your rental may need a lot of love before you bring it to market. If so, don't expect to get paid back from the sale with tax free dollars.

Any funds taken out of escrow are considered “boot” and taxable.





# Improvement Costs

## Costs to prepare the property for sale

- New Paint >Expense
- New Carpet >Capital Improvement
- Sewer >Capital Improvement
- Fixing the deck >Expense
- Fixing the leaky roof >Expense
- Repairing the A/C >Expense
- Replacing the A/C >Capital Improvement



# Same Taxpayer Requirement

## Requirement:

Taxpayer who sells must be the same taxpayer who buys!

## Issues/Problems:

- LLC's
- Trusts





# Same Taxpayer Requirement

Seller	Buyer	Allowed?
Mom & Pop	Disregarded LLC	Yes
Mom & Pop	Revocable Trust	Yes
Mom & Pop	Multi-Member LLC	No
Mom & Pop	Irrevocable Trust	No



# Boot

## Facts

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

Boot:	\$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

## Facts

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

Boot (Debt Relief):

**Tax liability:**

\$200K

**\$66K**



# Boot

## Facts

<input type="checkbox"/> Sale Price	\$500K
Equity	\$300K
<input type="checkbox"/> Replacement Purchase	\$475K
Equity	\$300K
Debt	\$175K

Boot:	\$25K
Tax liability:	\$8K



# ID Nightmares

## Identification

- ✓ 3 Property Rule
- ✓ 200% Rule

## Identification Letter

Address, City, State

Sale Price

Relinquished Property: \_\_\_\_\_ \$ \_\_\_\_\_

Client Name: \_\_\_\_\_

Regulations require that identification of replacement properties be made within 45 days of the close of your relinquished property. Two rules and one exception apply for all identification. Please check the box that indicates your method for identification:

- ☐ The Three Property Rule - Any three properties of any value may be identified.
- ☐ The 200% Rule - Any number of properties provided the aggregate value not exceed 200% of the value of the relinquished property. Please attach list of properties.
- ☐ The 95% Exception - Any number of properties of any value, provided that at least 95% of the identified property value is acquired within 180 days. Please note that this exception is very rarely, if ever used. Please attach list of properties and also contact Asset Exchange to inform us that you will be using the 95% Exception.

Address, City, State (include unit # if applicable)

Ownership %

Est. Purchase Price

Property #1 \_\_\_\_\_ \$ \_\_\_\_\_

Property #2 \_\_\_\_\_ \$ \_\_\_\_\_

Property #3 \_\_\_\_\_ \$ \_\_\_\_\_

How many properties will be acquired? If unsure at this time, please state "Unknown".

- ☐ One (1) ☐ Two (2) ☐ Three (3)
- ☐ Unknown ☐ Other (specify) \_\_\_\_\_

Signature (All parties, Including Spouses)

Date

THIS FORM MUST BE SUBMITTED NO LATER THAN DAY 45 OF YOUR EXCHANGE. RETURN BY EMAIL IS PREFERRED, EMAIL TO ADAM@AX1031.COM (PLEASE KEEP COPY OF YOUR SENT EMAIL). IF RETURNED BY FAX, PLEASE SEND TO 877-480-1031 AND TIME STAMP FAX, IF POSSIBLE. IN ADDITION TO EMAILING OR FAXING TO ASSET EXCHANGE COMPANY, YOU MAY WANT TO FAX OR EMAIL TO YOUR CPA OR TAX ADVISOR AS ADDITIONAL EVIDENCE OF IDENTIFICATION. SIGNATURE OF THIS FORM ALSO CONFIRMS EXCHANGOR HAS READ "IMPORTANT NOTES", ATTACHED TO THIS DOCUMENT.

Phone: (877) 471-1031 info@ax1031.com

Fax: (877) 480-1031 www.ax1031.com



# Seller Financing Issues

## **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.**



# Contact Info

## Asset Exchange Company



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