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**QIForum**  
**2008**

**QIForum** provides timely industry news, articles and information  
surrounding the strategic use of Section 1031.

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## QIForum 2008

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*Presented by Release Date*

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## WHAT REAL ESTATE AGENTS NEED TO KNOW ABOUT SECTION 1031

*It's clear that Section 1031 tax-deferred exchanges provide real estate agents a tremendous opportunity to increase commissions. But more importantly, you are serving your client's best interest when you are able to recognize an opportunity for a tax-deferred exchange. Think about it. What's better for your client? Paying taxes, or being able to put more money into a property by deferring those taxes? At Edmund & Wheeler, we say, "Help your clients grow their investments, not their tax bills!" We also say, "Help yourself by helping your clients."*

Here are a few questions that are commonly asked by real estate agents:

### Q: WHO SHOULD I CONTACT TO SET UP AN EXCHANGE?

**A:** As you might expect, we strongly suggest that you call Edmund & Wheeler, Inc. at 603-444-0020. We can act as the intermediary for your exchange anywhere in the United States.

### Q: WHEN SHOULD I CALL EDMUND & WHEELER?

**A:** Contact us as soon as you recognize that your transaction might be a candidate for an exchange. We will be happy to consult with you and your client to determine whether the client's situation warrants an exchange, and we'll be straight with you if it doesn't. For a complicated transaction, consultation may involve the client's legal and/or tax adviser(s). We are not attorneys or accountants, and as an intermediary we are specifically restricted from providing legal or tax advice. We always suggest that the client discuss his plans with his trusted advisers to make the final determination regarding an exchange. Our fee only applies when an Exchange Agreement is executed, so take advantage of our consultation offer. The bottom line answer to the question is to involve us as early in the transaction as possible.

### Q: WHAT CONTRACT LANGUAGE SHOULD BE ADDED TO THE PURCHASE AGREEMENT?

**A:** You can add the language below to your Purchase Agreement, which will notify the buyer of the seller's intention to perform a tax-deferred exchange. It also makes it clear that the other party will incur no additional cost or liability as a result of his or her cooperation. A clause such as this is not *required* for a tax-deferred exchange, but it is usually better to keep all parties informed from the outset.

*"It is the intention of the Seller to transfer the above-listed property pursuant to Internal Revenue Code Section 1031, which sets forth the requirements for tax-deferred real estate exchanges. Seller's rights and obligations under this and future agreements will be assigned to Edmund & Wheeler, Inc., Qualified Intermediary, for the purpose of completing an exchange. Buyer of the above-listed property agrees to cooperate with Seller and Edmund & Wheeler in a manner necessary to enable Seller to complete said exchange. Such cooperation shall be at no additional cost or liability to Buyer."*

When your client is ready to purchase his or her replacement property (the new property), the same language can be added to that Purchase Agreement, substituting "Buyer" for "Seller" and "Seller" for "Buyer." In this case, your client may wish to add the clause after the initial terms of the deal have been established. Some buyers feel that by disclosing the fact that the transaction is part of a Section 1031 exchange, it may provide the seller reason to negotiate more firmly, thinking that your buyer may be in a position of *needing* to buy the property in order to complete his exchange.

**Q: WHAT TYPES OF SITUATIONS ARE SUITABLE FOR A SECTION 1031 EXCHANGE?**

**A:** Every time you list any property that may have been "held for investment" (e.g., rental house, second or vacation home [there are specific restrictions on this type of property, however], duplex, office building, commercial building, apartment building, raw land, etc.), or has been used in the pursuit of a business or a trade (e.g., auto body shop, office condo, etc.) recommend that your client talk to his or her legal and/or tax advisers about the benefits of a §1031 exchange. You can also call us for a consultation, with or without your client. Call us if you'd like to run the situation past us to see whether it's a possible candidate. Too often, your client will think, "Well, I'll just pay the 15% federal capital gain tax and not worry about it," without thinking about the cost of state capital gains tax and depreciation recapture.

As a licensed professional, a real estate agent cannot afford to say, "I don't know about exchanges because I specialize in residential." Remember, you are working in your client's best interest by raising the possibility of an exchange.

**Q: CAN A SECTION 1031 TAX-DEFERRED EXCHANGE BE SET UP AT THE LAST MINUTE?**

**A:** Yes. *As long as the transaction has not closed*, Edmund & Wheeler can successfully convert a sale into an exchange. Documents can be prepared and delivered to the title company within a short period of time if necessary. Obviously, it's to everyone's benefit to have more time to consider the situation, but we can act on short notice if needed. However, once the closing has occurred, even if the seller has not deposited the proceeds check, it is too late...

In closing, remember this - it will not hurt anything to investigate the possibility of structuring an exchange. And think about this - how will your client feel about you if s/he does not know about exchanging, but finds out after the sale closes? As a real estate professional, you owe it to your clients to recognize the viability of exchanging. Conversely, you can be a hero and create a client for life if you bring it up and s/he happens to be hearing about it for the first time, or hadn't thought of it relative to this particular transaction.

## RESIDENTIAL/BUSINESS PROPERTY EXCHANGES

It is possible to sell a property that has been used for both business purposes and residential and use the benefits of Section 1031(Tax Deferred Sales) and Section 121 (Sale of Personal Residence) simultaneously. A clear differentiation in the books and records of the taxpayer on the portion of the property that has been used for business versus the portion that is used for personal use must be present. A classic example is the taxpayer that has operated an owner occupied bed and breakfast, using the property as part personal residence, part business property. The same principle applies for the taxpayer that deducts a portion of his/her residence for a home office (business use).

Section 1031 can be an effective strategy on the sale of a primary residence that contains excess land surrounding a personal residence (investment property). For example, a taxpayer owns a personal residence situated on 25 acres of land. It has been determined that the usual and customary acreage for similar properties in the vicinity is 3 acres. If the taxpayer has been holding the 22 excess acreage for investment, then that portion of the property can be treated as an exchange. A case in point: if the total value of the property is \$800,000.00 (assuming very low basis) and the residential exclusion can be utilized for up to \$500,000.00 of the gain, then it is possible to protect the \$300,000.00 balance as a tax deferred exchange and avoid any capital gains tax.

Section 121 provides for exclusion from gain up to \$250,000.00 per taxpayer or \$500,000.00 for a married couple filing jointly after two years of ownership. There is no longer a requirement to reinvest the capital gain from the sale of your primary residence into another primary residence; this exclusion can be used every two years.

Taxpayers selling their mixed use property must be aware that they will be subject to capital gains on the sale of the business portion of the property at the rate of 15% and recapture of past depreciation at the rate of 25% if they don't use the provisions of I.R.C Section 1031. Further, many states also impose a capital gains and/or business profits tax that could be due upon the sale of the property.

Tax Court Memo 2006-33, a mixed use case that was part business, part residential provides further insight into how this technique can be utilized. The outcome of this case is that clients who exceed the personal use limitations (14 calendar days or 10% of the days actually rented, whichever is greater) will run the risk of having their deductions disallowed. In summary, the case is this: "Because petitioners use a portion of their bed and breakfast inn as their personal residence, the general disallowance rule of sec. 280A(a), I.R.C., and the exclusive-use limitation of sec. 280A(f) (1) (B), I.R.C. are applicable, and expenses relating to the portion of the inn that is used for both business and personal purposes (i.e., dual-use portion) are not allowable." Clear books and records will avoid the pitfalls while allowing substantial tax benefits.

## THE POWER OF SECTION 1031

### *Cash, Contribution, Bargain Sale, Installment Note & Section 1031*

The object of a Section 1031 Exchange is to completely defer the capital gains tax, both federal and state, upon the sale of business or investment property and avoid any recapture of previously taken depreciation. It is necessary to go even or up in value, use all of the net cash from the sale of the old property and replace any debt that is paid off from the result of the sale. Since all real estate is "like-kind" all other real estate, the next hurdle is to identify the target property within 45 days of the sale of the Relinquished Property and acquire it within 180 days.

There are numerous ways to utilize Section 1031 without exchanging full value for value and still realize partial or full tax deferral. For example, it is possible to take cash at the closing of the Relinquished Property, however, that cash will be immediately subject to capital gains tax and recapture of depreciation and will negate the tax deferral that is the object of an exchange. It is also possible to sell the property using the installment sale method, thereby deferring the payment of tax until the actual receipt of the funds, presumably, over time. There is risk in positioning yourself as the lender, so beware. The other possibility is to create a structured sale by assigning the contract to a third party (usually an insurance company utilizing an annuity) who will provide a fixed return based on time and value.

An option with social impact is to sell the existing or relinquished property using a bargain sale. The notion of a bargain sale (a sale where the realized value is less than market value) conjures up visions of tax loss not capital gains. Bargain sales, whether in full or in part, to a qualified 501(c)(3) not-for-profit entity or municipality can produce several levels of tax benefits to the seller of the property. A case in point to illustrate: A property owner sold a tract of land to a nonprofit land trust and agreed to accept a lower price (bargain sale) for the opportunity to take a tax deduction for a charitable contribution. The market value of the property was \$160,000, the land trust agreed to purchase the property for \$90,000 and a charitable deduction of \$70,000 will be applied over the next five years against 50% of the individual's adjusted gross income (AGI). \$90,000 is exchanged for new Replacement Property by employing a Qualified Intermediary (QI). No tax is triggered at the time of sale; the personal income tax burden over the next five years is substantially cut; and new property is acquired using a Section 1031 Exchange.

This strategy will also work for the sale of conservation easements when the value of the development rights are sold and the underlying real property *remains* in the hands of the owner. Many small volunteer run land trusts operate nation-wide, protecting and preserving this country's unique character on a state by state basis. They are frequently asked to accept a donation of a conservation easement in exchange for cash. Since typically the cash must come from donations, this process is lengthy and often ranked on a priority basis. It can take years to raise the cash needed to protect a single project. One solution is to have the easement donated as a combined bargain sale of cash and tax deductions. With a sixteen year carry-forward for the tax benefits of up to 50% of the donor's adjusted gross income, dramatic benefits can be realized under such a plan and the landowner can acquire new property with the cash portion of the sale.

Case Study Scenario: Client has approached the local land trust to donate a conservation easement on his 250 acre farm. The land is open and adjacent to other conserved property and has a development value of one million dollars. The client wants to preserve the property but is approaching retirement age and would like to have some cash and be in a position to acquire an investment property in Arizona to be rented to others. The client has indicated that he is unable to make a large donation but since he expects to continue working for the next five years, tax credits will be helpful.

The trust offers \$500,000 for the easement; \$250,000 will be designated as a bargain sale and deducted over time using up to 50% of the client's adjusted gross income (AGI). The balance will be raised by the land trust and targeted donors. The client employs a Qualified Intermediary (QI) to handle the transaction as a partial Section 1031 Exchange. At closing, the client decides to receive \$50,000 in cash and directs the balance of the funds to the QI, which are used to acquire property in Arizona, identified in 45 days and acquired in 180 days. The client earns \$100,000 AGI annually, allowing for a 50% deduction of the AGI, he will pay income tax on only one-half of that amount for the next 5 years.

It is easy to see the Power of Section 1031 and the many options that are available on the sale of business/investment property. Whether Replacement Property is the desired goal or a combination of cash, new property, installment sale or tax deductible contribution, Section 1031 can provide the pathway to your property investments.

## SECTION 1031 EXCHANGES FOR THE REAL ESTATE PROFESSIONAL

### *A Multiple 1031 Strategy Can Have Dramatic Effects on Investment Portfolio*

These are some helpful tips and investment strategies using 1031 exchanges along with other 1031 "basics" that you should know about. The 1031 tax-deferred exchange is much more than selling a rental house and then buying another rental house. It requires a dedicated focus and guidance from a knowledgeable real estate professional. Today's sophisticated real estate investor can impact their portfolio dramatically by employing a variety of 1031 exchange techniques.

Why do a 1031 Exchange? No matter how nice your rental is, no matter how well built, if it's a 65-year-old home with three bedrooms and two full baths, its closets are probably too small and the kitchen is still decorated in the "I Love Lucy" era fashion. There's no great room, and no cathedral ceiling. In an era when people eat out or eat quickly, a great dining room has less appeal than in the past. Simply put, a lot of renters are interested in features not found in this type of home.

On a personal level none of this bothers us. But in the contest for good renters -- folks who will be caring stewards of the property and pay their rent in full and on a timely basis -- newer properties seem consistently more attractive.

Those savvy about 1031s can start thinking creatively. For instance, one way to ensure that you see your college-attending child from time-to-time is to purchase a property in the college town and hold it as a rental, and do a 1031 exchange after graduation. Getting tired of collecting rent and watching your residential investment property deteriorate from uncaring tenants? Are you afraid to sell after making such huge gains in the market? 1031 exchange will allow you to exchange a residential property for a business, or office rentals with a better paying clientele.

Exit Strategy: The lifecycle of a real estate investor tends to evolve to the point that one day; the investor would like to slow down, cash out, or retire. Whether the investor owns rental houses, warehouses, land, office buildings, or apartment complexes, a potential replacement property could be a well-located, residential property in a resort community in an attractive setting - such as a beach resort or mountain property.

To qualify for tax-deferred status, if those properties are purchased through a 1031 exchange transaction, they must be held for investment. To demonstrate the intent to hold for investment, most investors simply put those properties on a rental program with a management company or manage the property rentals themselves. However, at some point in the future, that same investor has the opportunity to employ a very powerful tool known as conversion.

Suppose several years after completing the 1031 exchange, the investor elects to move or retire full-time to the beach (or the mountains, lake, or golf community.) At the time the investor moves into the previously rented investment property, no tax obligations are due. The investor simply converts a property held for investment into his or her primary residence. The ultimate opportunity comes several years down the road, if and when the investor decides to sell the newly converted residence. At the time of that sale if the homeowner meets the residence requirements of ownership, occupies the property for at least two years, and held that previously 1031 exchanged property for at least five years, he will qualify for the \$250,000 or \$500,000 residential sale exclusion.

## THE POWER OF SECTION 121

### *Sale of Personal Residence*

The sale of your personal residence can be a stressful event; all that packing, arranging for the big day and the transfer of your sacred home to new owners is enough to bring you to your knees. And then, suddenly you think, "what about the taxes?" The good news is that Section 121 of the Internal Revenue Code provides for an exemption from gain upon the sale of your home if it has been your primary residence for two of the past five years. The exemption amount is \$250,000 per individual or \$500,000 for a married couple filing jointly.

There are numerous ways to utilize Section 121 without triggering tax. The biggest hurdle is to meet the residency requirement of 2 of the last 5 years. It doesn't matter if you are residing in the property at the time of sale as long as you meet the 730-day residency test. There is no requirement to reinvest the sale proceeds in another primary residence or any real property for that matter. If you acquire a new personal residence without selling your existing property, you have three years from the move out date to still utilize Section 121 before paying capital gains tax. This presupposes that you have not used Section 121 to exclude gain on any other property in the meantime. It can only be used every two years.

But what do you do if the gain amount exceeds the limitations? One practical answer is to take back financing for the excess amount using the installment sale method, thereby deferring the payment of tax until the actual receipt of the funds, presumably, over time. There is risk in positioning yourself as the lender, so beware. The other possibility is to create a structured sale by assigning the contract for the excess amount to a third party (usually an insurance company utilizing an annuity) who will provide a fixed return based on time and value.

As you can see, if the gain amount exceeds the limitations then you need to be more strategic in your planning. Another possibility is for the property to be occupied by yourself, your wife and one of your offspring (or other family member) for two of the last five years and to have the ownership of the property as tenants-in-common naming all three in the deed. Upon sale of the property, each party is entitled to a \$250,000 exemption from tax. Of course, all of this requires good planning and residency by all three parties.

Review the make up of your primary residence asset; does it contain excess land that has been held for investment during your ownership or has part of the property been utilized for business purposes, such as a home office? If any of these scenarios fit, then you need to examine how Section 121 can be used in concert with Section 1031 simultaneously to defer the gain on the sale of the investment/business portion of the property. A clear differentiation in the books and records of the taxpayer on the portion of the property that has been used for business versus the portion that is used for personal use must be present. A classic example is the taxpayer that has operated an owner occupied bed and breakfast, using the property as part personal residence, part business property. Section 121 provides partial protection from tax and Section 1031 provides additional protection as long as the business/investment portion is reinvested into "like-kind" property within 180 days and handled by a Qualified Intermediary.

Section 1031 can be an effective strategy on the sale of a primary residence that contains excess land surrounding a personal residence (investment property). For example, a taxpayer owns a personal

residence situated on 25 acres of land. It has been determined that the usual and customary acreage for similar properties in the vicinity is 3 acres. If the taxpayer has been holding the 22 excess acreage for investment, then that portion of the property can be treated as an exchange. A case in point: if the total value of the property is \$800,000.00 (assuming very low basis) and the residential exclusion can be utilized for up to \$500,000.00 of the gain, then it is possible to protect the \$300,000.00 balance as a tax deferred exchange and avoid any capital gains tax. The land value must support the excess value being claimed.

Taxpayers selling their mixed use property must be aware that they will be subject to capital gains on the sale of the business portion of the property at the rate of 15% and recapture of past depreciation at the rate of 25% if they don't use the provisions of IRC Section 1031. Further, many states also impose a capital gains and/or business profits tax that could be due upon the sale of the property.

It is easy to see the Power of Section 121 and 1031 and the many options that are available on the sale of your personal residence and business/investment property. Whether Replacement Property is the desired goal or a combination of cash, new property, installment sale or tax-deferral, Section 1031 can provide the pathway to building a solid financial future.

## REVERSE EXCHANGES - BUY NOW & SELL LATER

Section 1031 of the Internal Revenue Code provides for the ability to exchange your existing property for new property without triggering capital gains tax, a provision that has been in the Code since 1921. While it has been enhanced and tested by case law since that time, it was Revenue Procedure 2000-37, approved in September of 2000, which codified the safe harbors for exchanges done in reverse. A Reverse Exchange is simply where the new property is acquired before the old property is sold, thereby enabling the taxpayer to accomplish a qualifying like-kind exchange. Reverse Exchanges are an exceptionally powerful tool for the client who must act on the purchase of the new property immediately since the rule prohibits the client from owning both the new property and the old property at the same time and still get tax-deferred treatment. Reverse Exchanges are not for the faint of heart, but they work to preserve the tax deferral. This is good news for prospective clients that have identified the property that they want to acquire (Replacement Property) before they have found a buyer for their existing property (Relinquished Property). With the current real estate market, it may take longer to sell your current property, yet you don't want to miss the opportunity to acquire the new property while the price is right.

A Qualified Exchange Accommodation Arrangement or QEAA is created by a Qualified Intermediary who acts as the Exchange Accommodation Titleholder or EAT. The following example will assist in understanding the principles at work:

Our client, Blue Moon, LLC, (Blue Moon) identified a target property that was only available if Blue Moon could acquire it before the end of the month. Blue Moon wanted to sell three of its existing properties to fund the transaction. We described the mechanism that could accomplish the transaction noting that the Code requires that the ownership cannot be by the taxpayer or a disqualified person and that the taxpayer must have a bona fide intent to treat the transaction as an exchange. We went to work creating an Agreement that called for Edmund & Wheeler, Inc., Qualified Intermediary, to create a single purpose entity, Acorn, Inc. to hold title to the desired property. Once the corporation (the EAT) was created and the Agreement signed by the client, Acorn, Inc. was positioned to acquire the new property. The purchase was funded by means of an equity loan that Blue Moon arranged for with its lending institution using the existing property equity positions loaned to Blue Moon and a first mortgage on the new property, with Acorn, Inc. as borrower and the principal of Blue Moon as guarantor.

Acorn, Inc. acquired title to the target property and leased it to Blue Moon for its immediate use. In the meantime, Blue Moon listed its three existing properties for sale and within 45 days of Acorn, Inc. acquiring the target property it identified these three properties to Edmund & Wheeler, Inc., the Qualified Intermediary. Blue Moon went to work to sell as many of the properties that it could within 180 days so that the target property could be deeded from Acorn, Inc. to Blue Moon.

Blue Moon was diligent in its sale of the existing properties but was only able to sell two of the three it identified for sale. The sales proceeds of the two that did sell were passed through to the Qualified Intermediary and just prior to the 180<sup>th</sup> day, the equity loan was paid down and the target property was deeded from Acorn, Inc. to Blue Moon, LLC.

## WHAT IS LIKE-KIND PROPERTY?

*Myth Busted: "Like-kind" means ANY real property can be Exchanged for ANY real property. Don't get caught with the assumption that land can't be exchanged for an apartment building.*

The term Like-Kind appears in the Internal Revenue Code (IRC) in connection with Section 1031 Tax Deferred Exchanges and also in connection with Section 1033, Involuntary Conversions. Its largest application is in Tax Deferred Exchanges. When applied to a Tax Deferred Exchange, the term "Like-Kind" is a term of art that simultaneously means four things:

### Location, Type, Use, and Value

#### Location of Property:

For a property to be Like-Kind to another property, both must be *located* in the United States (the 50 states, or Washington, DC), or both must be *located* outside the United States. The US possessions are outside the United States.

For example, Colorado property is Like-Kind to New Mexico property, but not Like-Kind to Canadian property. British property is Like-Kind to French property, but not Like-Kind to New York property.

#### Type of Property:

### What Qualifies for an Exchange?

**Any real property that is held for investment purposes:**

- Land (even land that is part of your residence)
- Single-Family Dwellings
- Multi-family Dwellings
- Condos
- Co-ops
- Second Homes— Must Follow Rules!
- Strip Malls
- Office Buildings
- Apartment Buildings
- Commercial Buildings Of All Types



For a property to be Like-Kind to another property, both must be of the *same type*. Real Property is Like-Kind to all other Real Property, and the degree of improvement of each is immaterial. For example, vacant land is Like-Kind to a condominium.

The like-kind test is more stringent for Personal Property. For an article of Personal Property (i.e.: a backhoe) to be Like-Kind to another article of Personal Property, both must appear in the same 6-digit product code category of

the North American Industry Classification System (NAICS). The first digit must be a "3"; the second digit may be a "1, 2, or 3", and the last digit may not be a "9".

The NAICS Code for a backhoe is 333120 (Construction Machinery Manufacturing). Examples of other items in this category that are of Like-Kind to a backhoe are bulldozers, off-highway trucks and road graders. See [www.census.gov/naics](http://www.census.gov/naics).

The Personal Property rules are lengthy and complex, and a full treatment is beyond the scope of this QI Forum.

### Use of Property:

For a property to be Like-Kind to another, both properties must *be used by the taxpayer in a Trade or Business*, or for Investment. Trade or Business Property and Investment Property are but two of the four broad types of property addressed by the IRC, the other two are Personal (Use) Property and Dealer Property. Personal (Use) Property is property used by the taxpayer for personal purposes, for example, a residence or vacation home, or a personal automobile. Dealer Property is property that the taxpayer “deals in”, meaning property that is held primarily for sale such as lots, spec houses, or motor vehicles. Personal (Use) Property and Dealer Property may not be exchanged, but Trade or Business Property and Investment Property can be exchanged. Both properties do not have to be the same use either: The given (Relinquished) property can be used by the Taxpayer for an Investment, for example vacant land, and the received (Replacement) property can be used by the Taxpayer in Trade or Business, for example, as a rental condominium.

### Value of Property:

The last element comprising the definition of Like-Kind is the *value* of the property. For one property to be of Like-Kind to another, the values of each must match. This doesn't require a one-for-one or property for property match; it's the value of what's being sold matched against what is being acquired.

Many properties can be exchanged for one property or vice-versa. The term “value” means the price that a willing, third party Buyer pays for the given (Relinquished) property, less transaction costs such as real estate commissions, legal and title fees, and transfer taxes. The term “value” also means the price that you are expected to pay for the received (Replacement) property, plus transaction costs such as buyer brokers, legal and title fees, and transfer taxes.

If the prices of the two properties don't match, to the extent there is a disparity, then property of an *Unlike Kind* will be subject to tax. This property is termed “Boot” or sometimes “Boot Property” and can be anything from cash to debt relief to personal property items added to make the transaction balance. Only the person receiving Boot pays taxes on it. *The goal in an exchange is to go even or up in value.*

### Summary:

Four elements must be simultaneously present for two properties to be of a Like-Kind with one another. They both must be in the US or both outside of the US, they both must be of the same type, both must have been used as the Taxpayer's investment or in trade or business, and both must be comparably valued. Section 1031 Tax Deferred Exchanges, when structured properly, avoid the receipt of un-like-kind property and exposure to taxable boot.

## CONGRESS TAKETH AWAY!

### *The Housing and Economic Recovery ACT of 2008 Effects Changes to Section 121*

Taxpayers who own a second home and want to defer the capital gain on sale have used one of two strategies to achieve tax relief. The property can be converted to rental property for a minimum of two years prior to sale and structured as a Section 1031 Exchange using a Qualified Intermediary with the acquisition of new Replacement property that is also rented for the first two years after acquisition. The second method is to simply move into the second home and declare it as your primary residence for a minimum of two years and when sold use the Provisions of Section 121, Sale of Primary Residence, to exclude \$250,000 of the gain per taxpayer or \$500,000 for a married couple filing jointly.

The first strategy allows taxpayers with the ability to walk away from the deferred tax indefinitely by exchanging again and again. The second provides an outright exclusion from the capital gains tax if it did not exceed the limitations. Since the primary residence exclusion can be used every two years, a planning opportunity for full tax escape has benefited thousands of taxpayers.

The Housing & Economic Recovery Act of 2008, signed into law on July 30, 2008, contains a restriction on the practice of converting your second home to your primary residence. It requires that the exclusion be prorated based on the time the property was used as a second home. The portion of the profit that will be taxed is based on the ratio of the time after 2008 that the home was used as a second residence or rented out to the total time that the taxpayer owned the property. The balance of the gain will remain eligible for the Section 121 Exclusion.

To illustrate the point a second home is owned for five years and converted to a primary residence after 2008 for two years prior to sale. At sale, the taxpayer will pay capital gains tax on 2/7 or 28.57% of the gain, the balance will be excluded up to the Section 121 limitations. The longer a property is owned, the lower the ultimate tax will be.

## CONGRESS GIVETH

### *First-time Homeowner Tax Credit*

The Housing & Economic Recovery Act of 2008, signed into law on July 30, 2008, provides an attractive tax credit for first time homebuyers. A first time homebuyer is someone who has not owned a home in the preceding three years. All homes, whether single-family, town homes or condominiums or new construction will qualify, however it must be used as the taxpayer's primary residence.

The tax credit is for 10% of the purchase price, up to \$7,500, but phases out for higher-income homeowners. Homebuyers who file as single or head-of-household can claim the full \$7,500 if their adjusted gross income is less than \$75,000. For married couples filing a joint return, the income limit doubles to \$150,000. Homeowners are eligible for the tax credit if they have purchased a home since April 8, 2008 or make a purchase before July 1, 2009.

This is a tax credit, not a deduction. It reduces the homeowners' tax bill by up to \$7,500 for the tax year in which the purchase was made. If you pay less than \$7,500 in federal income taxes, then the government will write a check for the difference in the same manner as an overpayment of your taxes. If a house is purchased this year, a tax credit for the 2008 tax year can be taken with a filing deadline of April 15, 2009. If a house is purchased next year by the end of June, a tax credit for the 2009 tax

year can be taken in the April 15, 2010 filing. It's a one-time credit; you don't get to keep taking it year after year.

There is a catch, and that is that the money has to be repaid over 15 years, starting two years after you buy the house. That makes the tax credit an interest-free loan. If you take the full \$7,500 tax credit, your income tax bill will increase by \$500 a year for 15 years. If you sell the house before then, you'll have to pay Uncle Sam the remaining balance.

## SECTION 121 EXAMPLE

"Congress did restrict a break for turning a second home into a main home: Some of the gain will be ineligible for the home-sale exclusion if the house is converted to personal use after 2008 and is later sold. The portion of the profit that's taxed is based on the ratio of the time after 2008 when the house was used as a second residence **or rented out** (emphasis added) to the total time that the seller owned the house. The rest of the gain remains eligible for the home-sale exclusion of \$500,000."

*Source – Kiplinger Tax Letter Volume 83 #15 July 25, 2008*

Taxpayer's original cost in his Relinquished Property is \$100K, with \$50K of depreciation already taken.

Sale price is \$400K, no debt, QI receives \$400K (neglect expenses).

Replacement Property is a Single Family House (SFH) costing \$400K on 1/1/09; adjusted basis is \$50K.

Owner enters the house as his home on 1/1/11, and sells it on 1/1/14 for \$600K. During the rental period he claimed \$10K more depreciation. Adjusted basis on 1/1/11 is \$40K.

Indicated gain at time of sale is \$560K. Under the OLD RULE, this married taxpayer would pay tax on \$60K, and exclude \$500K of the gain. Under the NEW RULE, this married taxpayer must make the following calculation:

Owned 5 years (denominator), rented for 2 years (numerator);  $2/5 \times \$560K$  gain is \$224K recognized, balance excluded.

The incentive is to reduce this fraction by either owning the property longer (increases denominator) or renting it out for less time (reduces numerator, but flies in the face of Rev. Proc. 2008-16).

It seems that the days of simply buying an SFH (or a series of SFH's) with your exchange dollars, and later converting it (them) to your principle residence(s), selling and eliminating \$500K at a time are over.

## NEW SECTION 121 RULES

UNQUALIFIED TIME % THAT APPLY TO RECOGNIZED GAIN ON THE SALE OF A PREVIOUS SECOND/RENTAL HOME ON/AFTER 1/1/09

ROW>> Months & years of total ownership COLUMN>> Months & years of rental and/or second home use ENTRY>> This C.G.% is unqualified/taxed.

Owned:	6	12	18	24	30	3	4	5	6	7	8	9	10	11	12
Rent/2nd															
0	100%	100%	100%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%
6	100%	100%	100%	100%	20%	17%	13%	10%	8%	7%	6%	6%	5%	5%	4%
12	N/A	100%	100%	100%	100%	33%	25%	20%	17%	14%	13%	11%	10%	9%	8%
18	N/A	N/A	100%	100%	100%	100%	38%	30%	25%	21%	19%	17%	15%	14%	13%
<b>24</b>	N/A	N/A	N/A	100%	100%	100%	50%	<b>40%</b>	<b>33%</b>	<b>29%</b>	<b>25%</b>	<b>22%</b>	<b>20%</b>	<b>18%</b>	<b>17%</b>
30	N/A	N/A	N/A	N/A	100%	100%	100%	50%	42%	36%	31%	28%	25%	23%	21%
3	N/A	N/A	N/A	N/A	N/A	100%	100%	60%	50%	43%	38%	33%	30%	27%	25%
4	N/A	N/A	N/A	N/A	N/A	N/A	100%	67%	67%	57%	50%	44%	40%	36%	33%
5	N/A	N/A	N/A	N/A	N/A	N/A	N/A	100%	100%	71%	63%	56%	50%	45%	42%
6	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	100%	100%	75%	67%	60%	55%	50%
7	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	100%	100%	78%	70%	64%	58%
8	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	100%	100%	80%	73%	67%
9	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	100%	100%	82%	75%
10	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	100%	100%	83%
11	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	100%	100%

**BOLD>> THIS IS THE MINIMUM TIME TO SATISFY BOTH SECTION 1031 AND SECTION 121; THE LONGER THE PROPERTY IS OWNED THE BETTER**

George Foss 9/02/08

## THE POWER OF SECTION 1031

### *Tenants-In-Common & Other Passive Real Estate Investments*

What every real estate investor wants to know is “How can I make Section 1031 work for me? Isn’t that just for investors who have multimillion-dollar properties?” And, the best question of all; “I want to sell my property and I don’t want to manage real estate again, how can I have my cake and eat it too?” The power of 1031 is that it is for every investor, regardless of size, as long as the current property has been used for business, productive use or investment purposes. So, no matter whether investors are selling a two family dwelling that they acquired five years ago, undeveloped land, a strip mall or shopping plaza or hotel property, 1031 is a powerful tool to defer capital gains and un-recaptured depreciation.

Investors that were previously chasing market appreciation have begun to realize that their investments must make financial sense and produce sufficient cash flow to justify their portfolio space. Section 1031 provides an avenue to redirect those investment dollars without incurring capital gains tax. Realigning their real estate portfolio may be the biggest favor investors can do for themselves in this tenuous market. There will be bargains in the marketplace as investors reinvent their strategies for long-term results and strong balance sheets will attract the financing to make the right acquisitions.

The biggest development in Section 1031 is the variety of replacement property choices that now exist. Previously, investors were confined to locating new property that would carry the same headaches of their old property. Revenue Procedure 2002-22 codified tenant-in-common (TIC) ownership and the birth of a new real estate industry.

Investors can become fed up with hands on management, endless capital improvements and ever-rising operating expenses, Section 1031 can be the solution to a perfect real estate exit strategy. Further, as the population matures, older investors are seeking income streams without the hassles of hands-on management. Now they can sell their property using a Section 1031 Exchange and acquire a TIC interest, handing over the management and profit and loss statement to a team of experts and receive a steady income stream. Another powerful aspect of Section 1031 is that eventually, investors can exchange into their dream house as their primary residence, having avoided capital gains altogether!

A wide range of properties are available and in a variety of markets (geographic) and market segments (tenant mix). There are strong markets throughout the country, as an example, medical facilities are expected to provide attractive returns for the future. Whether investors are concentrating on cash flow or market appreciation, there are choices that will meet virtually every appetite. TIC’s can be sold as either real estate or as securities and the TIC companies are committed to performing thorough due diligence on each prospective offering before it is presented for investor consideration. This due diligence, or the thorough analysis of property facts and risks, should be performed on every TIC offering before the decision is made to invest. TIC’s offer different risk and reward profiles, varying maturities, professional management and easy transitioning for every investor. TIC interests can be exchanged again upon sale (aka “swap till you drop”).

TIC's are NOT the only choice for passive real estate. An Umbrella Partnership Real Estate Investment Trust (UP-REIT) provides a mechanism to invest real estate exchange proceeds into real property that is later converted to marketable securities through the mechanism of Section 721. These products are sold by Securities Dealers and carry the scrutiny of the Securities and Exchange Commission. Sale will trigger tax but REIT shares are far more liquid than TIC interests.

The challenge for utilizing Section 1031 has always been finding the right Replacement property in the allotted 45-day time frame. Institutionalizing the process can result in a large list of potential properties. Even in today's challenging market, the best TIC properties don't stay in the marketplace for very long, so timing will still be critical. Having a due diligence package delivered to the investor with an offering certainly makes the process more palatable.

Its time for investors to take a hard look at their real estate portfolio and visualize realigning their holdings to produce long-term results; they will most probably recognize *The Power of Section 1031*.

*As Mark Twain once said "history never repeats itself; but sometimes it rhymes."*

## GIT 'R DONE IN 45 Days

The greatest challenge in satisfying the identification of new or replacement property in a Section 1031 exchange is doing so within 45 days of the sale of the old or relinquished property. The replacement options are very broad, so focusing in on the overall investment goal is key to making the right choices within this short time frame. In fact, the vast majority of Exchanges that fail are due to the inability of the taxpayer to identify.

### 3 Property Rule

The easiest way to comply with the identification rules is to identify three properties, typically called the "3 Property Rule." You must identify by street address, map and lot number or by deed reference. You can literally drive down the street and list three addresses and it would constitute a good list. The drawback to this strategy is that you may not be able to negotiate a purchase and sale agreement on any of the listed choices.

Some baseline due diligence is necessary, obviously, it must be listed for sale or you'll be barking up the wrong tree to get your purchase done within 180 days. The property must be located within the 50 states or the District of Columbia and it must be used in your business or trade or for investment upon your acquisition, it does not matter how the property is currently used. Once the 45<sup>th</sup> day goes by, no changes, alterations or substitutions are permissible. Conducting some due diligence during the 45 days will prevent the selections from being nullified later on.

### 200% Rule

Some investors will want to diversify their property interests by acquiring more than three properties. If more than three properties are desired, the total value of what is identified must not exceed twice the value of the property sold, commonly called the "200% Rule". If one large property is sold, this option provides lots of latitude to acquire many small properties.

### 95% Rule

There is one last rule to be aware of during identification, the "95% Rule". This allows you to identify as many properties as you desire, at any value. The tricky part of this rule is that you **MUST** purchase at **LEAST** 95% of the fair market value of the identified properties. As you can imagine, this rule is not for the faint of heart!

There are a few restrictions to be aware of:

- You cannot purchase property owned by a related party unless that related party is also doing an exchange. In brief, related parties are yourself, your spouse, your children, and your mother, father, brother, sister (by whole or half blood), and your grandparents or entities where you have a 50% or greater ownership. If you do business with relatives, both buyer and seller must agree to hold their positions for two years following the transaction and file IRS Form 8824 for the year of sale and the *next two tax years*.

- The new property must be titled in the same manner as the old property. The taxpayer identification number must be the same throughout the transaction; same person or persons or same entity.
- The new property cannot be used as your principal residence or for personal use upon acquisition. Personal use of the property is limited annually to 14 calendar days or 10% of the days actually rented, whichever is greater. The property can also be used during repairs or maintenance of the property, however, keep good records if you expect to support this claim in an audit. If you decide to rent to relatives, the rent must be fair market rent.
- The new property must clearly support the "investment intent" of the old property.

The next challenge is to match the value of the old property(ies) with the value of the new property(ies). The goal in an exchange is to go even or up in value, use all of the net cash proceeds and replace any debt given up on the old property with new debt on the new property. The sale proceeds cannot touch your hands (or your representative) so a Qualified Intermediary (QI) is employed to handle the transaction. The QI will produce a contract that must be in place prior to the closing and will direct that the funds be placed under the QI's control for the client's benefit for the purchase of replacement property. All of the closing documents should create a clear audit trail that it is the intent of the seller to conduct a Section 1031 exchange.

Replacement Property choices can include whole or partial interests, property rights, easements, subsurface property, land, improved or unimproved, single family, multi-family, retail, commercial, warehouse, manufacturing facilities, strip malls, condominiums, and seasonal property or any combination thereof.

The most successful exchanges will be a result of the ability to identify the right properties within 45 days, the remaining 135 days (180 all in) can be devoted to bringing the property to a closing. With some pre-planning and a little effort this process can go very smoothly and enable investors to meet their overall investment strategy. So, Get R' done!

## PAY THE TAX? NEVER

Capital gains tax is assessed upon the sale of real estate and certain items of personal property at the rate of 15%. It is calculated based on the original cost-plus improvements less cost of sale against the sale price. This is usually the result of market appreciation and constitutes equity in the property. While the rate is not insurmountable, it will likely be in excess of 20% in the not too distant future.

A second level of taxation is more eye opening; previously taken depreciation (the amount taken from May 6, 1997 to date of sale) is recaptured upon sale at the rate of 25%. Unfortunately, too many taxpayers dutifully pay the tax each year without understanding that the tax can be deferred, interest free, if the sale is handled as a Section 1031 Exchange. Section 1031 was first added to the Internal Revenue Code in 1921 and has been enhanced over the years. Every taxpayer regardless of whether that taxpayer is an entity or individual, as long as the property is not personal use property, can utilize exchanges as a tax deferral strategy and *never pay the tax*.

The first step is to engage the services of a Qualified Intermediary (QI) to facilitate the transaction as an exchange. The QI will create an Exchange Agreement and notify the parties involved of the sale. This must be done before you deed the existing property to its new owner. If the sale proceeds land in the hands of the seller or its representative, the tax is automatically triggered.

Finding the perfect replacement property can be stressful but it should never dictate whether the sale is handled as an exchange. Preserving your right to acquire new replacement property is essential to the preservation of your equity. By regulation, exchangers have 45 days from the date of sale to produce a list of possible replacement properties. If the intent is to acquire new property, set it up as an exchange before the sale. If suitable property cannot be acquired at the end of the identification period, the funds are returned to the seller on day 46 without fines or penalties, the tax is then triggered as if an exchange was not considered.

Replacement property options are diverse and can range from stand-alone real estate to interests in oil and gas (subsurface property rights) to easements, Tenants-In-Common (TIC) ownership, Umbrella Partnership Real Estate Investment Trusts (UP-REIT) or any property deemed to be real property under local law. The goal is to replace the old property with new property of equal or greater value, it can be in whole or partial interests in real property located anywhere in the United States.

Using Section 1031, there is never a reason to pay capital gains tax, NEVER!

## CASH; THE “FATAL ATRRACTION”

Real estate is a solid, practical and easy to understand investment vehicle. It is readily available in a variety of forms all across the United States. It can be acquired with cash, debt or exchanged for existing property holdings. Section 1031 Exchanges of real estate are the best way to maximize your cash flow and equity for long-term wealth building.

The sellers of real property are often too preoccupied with the sale to realize that if they were more strategic in their investment decisions they could reap long term financial benefits. The concept is simple, don't touch the cash! The object in an exchange is to defer the capital gains tax, recapture of previously taken depreciation and any state gain tax. If you go to the closing without employing a Qualified Intermediary (QI) to handle the sale as an exchange, the tax will be triggered as soon as the cash is touched. The time to defer the tax is before the buyer shows you the cash. If you focus on the cash, the fatal attraction, it will cloud the strategy to successfully do a Section 1031 Exchange. Employing a QI is paramount to setting up the sale as an exchange with all of its tax benefits.

If you came across a sign that said “the IRS is offering interest free loans”, you would stop in your tracks to find out the details. That is precisely what the IRS is saying by legitimizing Section 1031 Exchanges. Follow the rules, reinvest in real estate of equal or greater value and never pay any capital gains tax.

Don't wait until the sale is complete and you have the cash; it must be structured BEFORE the closing by engaging a Qualified Intermediary. The attraction to the cash will be result in just another tax fatality!

## THERE'S NO HARBOR LIKE A SAFE HARBOR

While Section 1031 has been in the Internal Revenue Code since 1921, it has been enhanced and expanded numerous times since inception. The 1991 regulations provided several "safe harbors" to protect transactions from being disallowed. These "safe harbors" define the edge of safety and effect when an exchangor is entitled to the receipt of exchange proceeds and are commonly referred to as the (g)(6) restrictions as derived from 1.1031(k)-1(g)(6).

The driving force of the (g)(6) provisions is the limitation that the exchangor has no rights (provided for in writing) to receive, pledge, borrow, or otherwise obtain the benefits of money or other property before the end of the exchange period. The net cash is sequestered away from the exchangor and placed in the hands of the Qualified Intermediary. In essence, the exchangor has no rights to the funds, only the property that can be acquired with the funds.

Full tax deferral of capital gain tax is achieved when the exchangor has gone even or up in value, used all of the cash in the qualified escrow account and replaced the debt given up with new debt on the acquired property. Some Exchangors will request that they receive cash at the time of closing to address other personal or business matters. The only conflict that surfaces is that by taking cash, they do so with the understanding that it may constitute taxable "boot" upon receipt.

Whether cash is or is not taken at closing, the next time period that the Exchangor can have access to the escrow funds is at midnight of the 45<sup>th</sup> day if no replacement property is identified. In this case, the exchange terminates and all of the proceeds are directed back to the exchangor. No penalty is assessed for this failed exchange and the taxpayer is now obligated to address the capital gain tax and recapture of previously taken depreciation.

If replacement property is properly identified within the 45 day time period, the next opportunity for cash is once all of the identified property has been acquired or midnight of the 180<sup>th</sup> day, whichever comes first. The only time the 180<sup>th</sup> day is interrupted is if the date falls beyond the due date of the taxpayers tax return. In this case, the taxpayer (ie: Exchangor) is encouraged to file for an extension of the due date to take full advantage of the exchange period. Exchanges must be conducted within the same tax year even if they pass through a year end which would normally create a carry-over situation.

If an Exchangor identifies three possible replacement properties and elects in the letter of identification to acquire only one of the three identified properties, then once the one property is acquired, any residual cash in the exchange is returned to the exchangor as taxable "boot" and the exchange is concluded.

Section 1031 is rule driven, abide by its warnings and stay out of stormy seas!

## RELATED PARTY EXCHANGES

Section 1031 Exchanges are a powerful tool in the deferment of capital gains tax from the sale of business or investment property. However, there is a prohibition for transactions with related parties. The general rule is that you can sell property to a related party but you cannot purchase related party property. The theory is that a third-party transaction is necessary to avoid basis shifting between related parties. The term "Related Party" will be defined below.

The first leg of an exchange is the sale of the business/investment property. The funds are directed to a Qualified Intermediary (QI) for the acquisition of Replacement Property. Within 45 days an identification letter is delivered to the QI, using the simple rules, three potential properties are identified. Any one, two or three of the properties can be acquired within 180 days. If a related party owns any one of the properties identified, the exchange will run the risk of being disallowed.

Revenue procedure 2002-83 codified related party transactions in Section 1031 Exchanges. There are two possible solutions that will comply with the safe harbor requirements. The first provides that if the related party selling to you is also conducting an exchange and both parties hold their new properties for a minimum of two years, then the exchange will be valid. This presupposes that the property you are acquiring has been business/investment property in the hands of your relative prior to sale. For example, if you identified target property owned by your grandparents and it has been a rental property in their hands and they will also conduct an exchange using a QI by acquiring other like-kind property, then your exchange will be successful. Both parties must file IRS Form 8824 for the year of the exchange and two additional years.

The second solution is to arrange for a direct swap of the properties currently owned by the related parties. The challenge in a direct swap is to equalize the values so that neither party receives unlike kind property, typically cash, or "boot". Often, related parties are trying to unwind joint ownership when they receive property in an estate, or co-own several properties together. Partial interests may be exchanged and they may immediately resell what they receive; no 2-Year Rule applies, provided the overall objective of the transaction is to enlarge or unify ownership of particular pieces of property. Once the parties reach agreement on who will retain the respective pieces, the next step is to have the interests appraised by an independent party to establish the values. Lastly, a transaction commences with some of the relatives giving up interests in property they no longer want in exchange for larger or complete interests in property owned by other relatives. If cash is received, for equalizations, it is taxed.

Another common situation arises when a relative wishes to buy your business or investment property. You conduct the sale using a Section 1031 Exchange and direct the proceeds to a QI for your acquisition of property from a non-relative **and** both you and the relative who purchased your old property agree not to resell for a period of 2 additional years, again filing Form 8824 as noted above.

So just who are your relatives anyway? Here is a partial list, taken from Section 267(b) of the IRS Code.

These *people* are Related Parties (to you):

Any of your lineal **ancestors**; any of your lineal **descendants**; any of your **siblings**, by whole or half blood; your **spouse**; and lastly, **yourself**.

And these *people* are **not** Related Parties (to you):

Any of your **aunts** or **uncles**; any of your **cousins**, any of your **nieces** or **nephews**, and any of your **in-laws**.

In *business*, these entities are Related Parties (to you; partial list).

You and any corporation (S-type or C-type) are Related Parties when you (and persons related to you) collectively own **more than 50%** of the capital stock of the corporation. Your shares and those of your wife (for example) are added together for purposes of the greater than 50% test.

You and any partnership or LLC are Related Parties when you (and persons related to you) collectively own **more than 50%** of the capital or profits interest in such entity. See example above.

A corporation (of either type) in which you (and persons related to you) are a stockholder, and another corporation in which you (and persons related to you) are also a stockholder are Related Parties if your collective stockholding in either corporation **exceeds 50%**.

Two Partnerships or LLC's are Related Parties when you (and persons related to you) collectively own **more than 50%** of the capital or profits interests in either entity.

The Settlor (Grantor) and any Trustee of the **same trust** are Related Parties.

Trustees of two different trusts are Related Parties if the **same person** Settled (Granted) both.

A Trustee of a trust is a Related Party to any **beneficiary** of that trust.

A Trustee of a trust is a Related Party to a beneficiary of another trust provided the **same person** Settled (Granted) both.

And in *business*, the following are **not** Related Parties (to you; partial list).

If you and your relatives collectively own 50% or less of the shares of a corporation, or 50% or less of the capital or profits interests in a partnership or LLC; you are still not related if you collectively own exactly 50%.

And with trusts, it's easy to see that if you are not among the group described above, then you are not Related Parties.

This list is not meant to be exhaustive. Please see IRC Section(s): 267(b); and 707(b)(1) and the supporting Regulations for the complete rules.

Section 1031 Exchanges involving Related Parties are always problematic, but not impossible to resolve. Good planning and sufficient time will resolve most related party issues.

## SPLITTING HEIRS

The transfer of wealth from one generation to another will hit its peak in just a few years and understanding the tax impact on the heirs is an important consideration. Traditionally, financial planners have focused most of their efforts on helping clients accumulate wealth, now is the time to plan for the transfer of that accumulation.

It has been reported that more than half of the nation's personal wealth is held in non-financial assets, such as houses, land, farms and personally owned businesses. Based on past experience, the value of this wealth will grow over the next half century, and at the same time most of it will change hands. The majority of this huge transfer of wealth will go to spouses, children and charitable causes. A significant portion also will go to state and local estate taxes unless a plan is developed to prevent it.

Section 1031 is the perfect strategy to assist clients in moving their active real estate investments into passive investments, without paying capital gains tax. Tenancy-in-Common (TIC) and Umbrella Partnership Investment Trusts (UP-REIT) properties provide an excellent transfer investment vehicle. Heirs will gain tax advantage through a stepped-up basis upon the death of the owner and they will not inherit deferred taxes or a management nightmare in the process. A sale of the property is not necessary; cash flow is easily divisible to the heirs if they elect to hold their newly inherited investments. Cash flow from passive investments takes little time and attention and there is less arguing between the inheriting parties.

Cashing out of wholly owned real estate requires an agreement of the parties as to broker selection and price. The sale of passive investments such as TIC's or REIT shares is simplified; TIC's are not generally sold until the entire project is sold or refinanced. A growing majority of REIT shares can be traded openly on the market in a variety of increments thereby negating the need to fully liquidate the investment. In either case, the sale of investment real estate by the heirs will be at a stepped-up basis so the assets can be passed without the deferred taxes.

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