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## *1031 Exchange Examples*

" Any time economic development takes place, and the developer/municipality would like to voluntarily acquire land from a private property owner, without using Eminent Domain, the Section 1031 Tax Deferred Exchange can be important.

Example 1 – a large technology company wants to locate in Central Iowa, wanting a highway frontage location, adjacent to town. The landowner is not interested in selling – not at all. The landowner wants to keep the farmland – really not interested in selling. The local economic development group was able to convince owners to do a 1031 Tax Deferred Exchange for other farmland in the area that was for sale, create a win-win-win. This would NEVER have been possible without the 1031 exchange.

Example 2 – small growing community needs to upgrade their municipal sewage treatment facilities, due to age and community growth, and environmental requirements. The municipality would like to locate it outside the city limits, and acquire sufficient land to provide a distance buffer and cropland on which to apply the solids-sludge from the sewage treatment process. They believe, with the ability to help a landowner/landowners with a 1031 Tax-Deferred Exchange, they can entice them to sell and will reduce the cost to acquire the land. Without the 1031 tax deferral on the part of farmer/landowners, the land would be virtually unavailable.

*Randy Hertz, ALC Advanced, AFM, CFP* *Iowa*

" I was recently visiting with a local farmer I knew was buying a farm by private treaty and selling another farm by private treaty. He was going to close on the farm he was selling and a week later close on the farm he was buying. I suggested he complete the 1031 exchange and saved about $30,000 in capital gains tax in the process. Hopefully, he will spend that extra money in the local economy, which I believe he will.

*Dan Roling, Agent* *Missouri*

" I should think a good argument for not ending the 1031 exchange is that it might hurt the economy. Every time property changes hands it creates economic activity. If 1031 exchanges are eliminated, people would be less likely to sell one property to purchase another, because of the tax consequences. They may tend to hold onto a property beyond whatever their original purpose for the property.

*John C. Chatelain, Attorney* *Nebraska*

" We all need to do as much as possible to get Congress to understand the negative ramifications of such possible action as to how it would affect the sale of land to others who have a sincere interest in owning land. If this should pass, it possibly could have the greatest negative affect on the real estate business we have ever experienced. I would really hope with the tremendous lobby power NAR has that strength in numbers will work. The agricultural sector is quite small in the eyes of congress and unfortunately has lost much power over the years, but we still need to be heard.

*Ray L. Brownfield ALC Advanced, AFM* *Illinois*

"I have been involved in several 1031 Exchanges over the years. For those in the farming industry, where longevity is the key factor, those who have been farming for more than 30 years likely purchased land for less than $1,000 per acre. That land is now selling for around $10,000 per acre. That is a HUGE hit in capital gains tax. But in addition to that, there is another 25% depreciation recapture tax on top of it. For those who have added grain storages, potato or onion storages, or some other substantial improvements, this can mean their hit could be as high as 40% in federal taxes. THAT IS HUGE! The only way a farmer can get out of paying the tax right now is for one of them to die! And that is very sad. Now, for them to be required to do an exchange to *defer* the taxes, we are asking them to do something they know nothing about. What will they exchange into? What they really want is to get the money out to enjoy life or to pay bills – perhaps long term care. And the government wants to take that away.

For commercial business people – they know about renting and leasing commercial buildings and have a better grip on exchanges. It is part of their portfolio to move through a building, fix it up and trade it for another one that they can increase the value on and repeat the cycle to improve their holdings.

It is my firm belief that the Investment Tax Credit of the '70's was the best tax move to help small businesses grow and improve the economy. I would prefer to see that come back into the picture. I would also ask what the government will replace 1031 exchanges with. Would it be a direct sales tax, income tax or what. If it becomes an income tax, it will throw a great number of people into the higher/highest tax bracket and "steal" even more of their money from the sale than the capital gains would have gotten.

*Flo Sayre, ALC Advanced, ABR, CNE, CRIS, TRC* *Washington*

"I was just contacted by a colleague in Montana who has a seller whose wife just died; they have agricultural land in North Dakota. The seller would like to move back to Montana where family is and purchase land in Montana so that he can continue farming. He will utilize a 1031 tax-deferred exchange in order to sell his North Dakota farm and purchase a ranch in Montana. He will defer the capital gains tax on the sale of the ND land and use the equity and savings for the purchase of the Montana ranch.

*Terri Jensen, ALC Advanced* *Nebraska/MN*

"An investor purchases an office building for $100,000. After 8 years, he decides to sell the property for $175,000 to purchase a strip mall. This sale would result in a $75,000 gain from his initial purchase. If the investor purchases the strip mall with the entire $175,000, his gain ($75,000) will **not** be taxed. Depending on his income and tax bracket, he would save between $7,500 and $26,000. In essence, the investor is using the full gain on the sale of his office building, while saving the taxes he would have paid on his gain: he is reinvesting into another income-producing property.

*Anonymous*

"There are some cynics that believe that you cannot avoid tax. At least for capital gains and depreciation recapture there is a tried and true strategy to successfully avoid the supposedly inevitable tax. That strategy is simple. Do not sell the investment property. Hold it until you die. Upon death there is the stepped up basis. That means that your heirs' basis is the market value of the property at the time of your death. Since capital gains tax is the difference between market value and the cost of the property, when your heirs inherit your property the IRS finds no capital gains are owed because of the stepped up basis rules your heirs cost basis and market value is the same at the time of the inheritance. Now if the heirs keep the property for some time and the market value increases, they will then have capital gains unless they adopt the "hold until death" strategy.

If you adopt the "hold until death strategy", are you stuck with the same investments until you die? The answer is no. The IRS allows you to exchange properties tax free if you do not convert any of the property to cash and then decide to not invest that cash into the exchanged property. The money that some withdraw from their investment is called "boot" by the IRS. Originally taxpayers were required to actually exchange their property with other taxpayers. That was the requirement until a taxpayer named Starker came up with the idea of allowing a taxpayer to sell his property, have a independent person or entity hold the proceeds, and then reinvest the proceeds in another investment property. The IRS did not approve that approach, but the US Supreme Court did. As a result of that decision the IRS adopted section 1031 of the Internal Revenue Code that sets up the rules for an "exchange" which in reality is a sale and repurchase done in accordance with those rules. Wikipedia has a great article explaining those rules. Check it out at this link: http://en.wikipedia.org/wiki/Internal_Revenue_Code_section_1031

If you do not need to sell your investments to use the money for other things, it is quite easy to hold them for your entire lifetime. "1031 Exchanges" allow you the flexibility to change those investments over your life to hopefully make them work better for you.

*Gordon Esplin, Attorney* *Colorado*

## *Book Example of a 1031 Exchange*

The following is an example of the 1031 exchange process. The following compares a typical sale and a 1031 exchange:

Bill decided to sell the condominium he has owned for 6 years (relinquished property). The property's current fair market value (F.M.V.) is $1,500,000; however, at the time he purchased the condo, the F.M.V. was $500,000. After Bill spent $50,000 in capital improvements and the property depreciated by $80,000, his adjusted cost basis was $470,000. Bill was advised by his tax consultant to engage in a tax-deferred exchange.

Bill's real estate broker discovered an apartment building for $2,750,000 (replacement property). Bill purchased the property using the net proceeds from the sale of his condo within the 180 day period and successfully completed the 1031 exchange.  If Bill had sold his condo without using a 1031 exchange, he would have paid $144,500 in federal taxes.

Through the use of a 1031 exchange, Bill deferred his capital gains and depreciation recapture taxes, and had $144,500 more to invest into a replacement property.

| | |
|---|---|
| **Original Purchase Price (relinquished property)** | $500,000 |
| **Capital Improvements** | $50,000 |
| **Depreciation** | $80,000 |
| **Adjusted Basis** | $470,000 |
| | |
| **SalePrice (assuming property sells at Fair Market Value** | $1,500,000 |
| **SaleExpenses** | $120,000 |
| **Net Sale Price** | $1,380,000 |
| **Realized Gain ( Net Sale – Adjusted Basis)** | $910,000 |
| | |
| **Depreciation Recapture ( $80,000 x 25%)** | $20,000 |
| **Capital Gains Tax ( $830,000 x 15%)** | $124,500 |
| **Total Federal Taxes** | $144,500 |

| | **Typical Sale** | **1031 Exchange** |
|---|---|---|
| **Net Profit (Realized Gain)** | $910,000 | $910,000 |
| **Total Federal Taxes Due** | $144,500 | $0 |
| **Equity to Reinvest** | $765,500 | $910,000 |

Part of the purpose of deferring taxes is to encourage those with income-producing properties to continue to reinvest in other income-producing properties --- the equity to reinvest is higher when capital gains taxes are deferred.

## *Sample Savings*

**Example Scenario 1**

Tim decides to sell a duplex that he has owned as an investment property for 10 years originally purchased for the amount of $70,000, and is now worth $750,000. His real estate broker has recommended that he engage Liberty 1031 to act as his Qualified Intermediary in a tax deferred exchange, thereby deferring payment of capital gains taxes. The real estate broker finds Tim an office building valued at $3,000,000 for his replacement property. Tim is successful in the exchange process and as a result does not have to pay capital gains taxes in the amount of $102,000. ($750,000 less original purchase price of $70,000 equals $680,000 profit. Capital gains tax is 15% times $680,000 equals $102,000.) He is able to purchase the office building leveraging the net proceeds from his duplex. Tim was able to purchase a property worth $408,000 more using the 1031 exchange.

| | Sale | Exchange |
|---|---|---|
| **NET EQUITY** | 680,000 | 750,000 |
| **CAPITAL GAINS TAX** | 102,000 | 0 |
| **EQUITY TO REINVEST** | 648,000 | 750,000 |
| **PROPOSED ACQUISITION*** | $2,592,000 | $3,000,000 |

*(Presuming 25% Downpayment)

**Example Scenario 2**

Isadora Investor owns a 10 unit apartment building, which she bought 3 years ago for $150,000. She discussed her situation with her Financial Advisor, who suggested she implement a 1031 Tax Deferred Exchange for the acquisition of a different investment property. Isadora has found a Buyer to purchase her apartment building for $900,000. Instead of selling the building directly, Isadora consummates a 1031 tax deferred exchange. As a result, she defers capital gains tax of $112,500 on her $750,000 profit ($900,000 less original price of $150,000 equals profit of $750,000 times 15% current federal capital gains rate equals $112,500 capital gains tax). Isadora uses Liberty 1031 as her Qualified Intermediary and closes on 60 acres of unimproved land at the purchase price of $3,600,000. No capital gains tax is then due as Isadora has completed a valid tax deferred exchange exchanging one investment property for another. Isadora was able to purchase a property worth $450,000 more using the 1031 exchange.

| | Sale | Exchange |
|---|---|---|
| **NET EQUITY** | 750,000 | 900,000 |
| **CAPITAL GAINS TAX** | 112,500 | 0 |
| **EQUITY TO REINVEST** | 787,500 | 900,000 |
| **PROPOSED ACQUISITION*** | $3,150,000 | $3,600,000 |

*(Presuming 25% Downpayment)