



**MINIMIZE TAXES, MAXIMIZE WEALTH:
UNDERSTANDING TAX DEFERRAL
STRATEGIES WHEN SELLING
REAL ESTATE** ©2011



Todd R. Pajonas, Esq., President
877-701-1031 todd@legal1031.com

WHAT THIS COURSE IS ABOUT

It's not what you earn.

It's what you keep.



WHAT THIS COURSE WILL COVER

- How to calculate basis, depreciation and taxable gain.
- IRC §1031 Tax Deferred Exchange
- Structured Installment Sales - IRC §453
- Replacement Property Strategies

BASIS, DEPRECIATION, CAPITAL IMPROVEMENTS AND CALCULATING CAPITAL GAIN TAX

COST BASIS, DEPRECIATION, CAPITAL IMPROVEMENTS AND DEPRECAITION

- In order to figure out a capital gain you must first determine the adjusted basis in a property.
- Many people talk about “basis” but “adjusted basis” is the figure that is important to figure out a gain.
- **Cost Basis** is generally what an investor pays for a property, plus closing costs. If the property is acquired in an exchange or non-arms length transaction the basis may be different.
- **Closing costs** do not include prorated items (e.g., taxes, insurance, rent); finance charges paid by the buyer; or expenses that physically affect the property (e.g., repairs)
- **Adjusted Basis** is the cost basis of the property, plus capital improvements, minus depreciation.
- **Capital Improvement** - If the improvement materially adds to the property’s value (not just a repair) and prolongs the property’s useful life.

WHAT IS DEPRECIATION?

- Depreciation is the periodic expending of an asset over the property’s theoretical economic life. IRC §1250
- This tax deduction is intended to recognize the decrease in value caused by, among other things, wear and tear, and outdated interior improvements.
- Depreciation benefits investors while they own a property and is a liability when a property is sold.
- An investor’s cost basis is reduced by the amount of depreciation they have taken.
- Land is generally not depreciable and an investor must allocate the purchase price between the land and improvements. (Properties rarely have a true zero basis.)

WHAT IS DEPRECIATION RECAPTURE?

- Depreciation not only causes a reduction in basis, but is taxed at the Federal level at 25%, instead of 15% capital gain tax rate.
- Most states do not have a separate rate specific to depreciation recapture. Instead, depreciation is taxed at a capital gain tax rate.
- For Federal tax purposes the adjusted basis must be divided into gain from appreciation and depreciation.
- Property that has not appreciated can still have a gain due to depreciation recapture.

SAMPLE DEPRECIATION SCHEDULE

Period	Year	Book Value Period Start	Depreciation Expense	Accumulated Depreciation	Book Value Period End
1	2000	\$1,000,000	\$24,573	\$24,573	\$975,427
2	2001	\$975,427	\$25,641	\$50,214	\$949,786
3	2002	\$949,786	\$25,641	\$75,855	\$924,145
4	2003	\$924,145	\$25,641	\$101,496	\$898,504
5	2004	\$898,504	\$25,641	\$127,137	\$872,863
6-35	2005- 2034	\$872,863- \$129,274	\$25,641	\$152,778- \$896,368	\$847,222- \$103,632
36	2035	\$103,632	\$25,641	\$922,009	\$77,991
37	2036	\$77,991	\$25,641	\$947,650	\$52,350
38	2037	\$52,350	\$25,641	\$973,291	\$26,709
39	2038	\$26,709	\$25,641	\$998,932	\$1,068
40	2039	\$1,068	\$25,641	\$1,000,000	\$0

FIGURING OUT A CAPITAL GAIN

1st Calculation: Net Adjusted Basis

Original Purchase Price (Cost Basis)	\$400,000
Add: Capital Improvements	+ 50,000
Less: Depreciation	- 75,000
Equals: Net Adjusted Basis	\$375,000

2nd Calculation: Capital Gain

Today's Sales Price	\$750,000
Less: Net Adjusted Basis	- 375,000
Less: Cost of Sales	- 25,000
Equals: Capital Gain	\$350,000

3rd Calculation: Tax Due

Recaptured Depreciation Straight-line ($\$75,000 \times 25\%$)	\$18,700
Federal Capital Gain ($\$275,000 \times 15\%$)	\$41,250
State Tax ($\$350,000 \times 7\%$)	\$24,500
Total Tax Due	\$84,450

BENEFIT OF DEPRECIATION

The following examples show the benefit of depreciation deductions:

	Example 1	Example 2
Fair Market Value (FMV)	\$6,000,000	\$6,000,000
Net Operating Income (NOI)	\$540,000	\$540,000
Debt Service Payments		
Principal	\$86,400	\$86,400
Interest	<u>\$345,600</u>	<u>\$345,600</u>
Total Debt Service	\$432,000	\$432,000
Before Tax Cash Flow (BTCF)	\$108,000	\$108,000
Add back Principal	\$86,400	\$86,400
Deduct Depreciation	<u>-\$123,077</u>	<u>\$0</u>
Taxable Income	\$71,323	\$194,400
Tax Due 40%	\$28,529	\$77,760
After Tax Cash Flow (ATCF)	\$79,471	\$30,240

COMMON MISCONCEPTIONS REGARDING GAIN

- Gain is the amount of equity left in the property.
- If a property is foreclosed there is no gain.
- If an investor buys a property for \$3M, and it rises to \$5M, before retreating to \$4M, at which point it is sold, the investor has a \$1M loss.
- If an investor did not take depreciation that they were entitled to they do not have to worry about depreciation recapture when they sell.

IRC§1031 TAX DEFERRED EXCHANGES

OVERVIEW AND MYTHS OF AN IRC §1031 TAX DEFERRED EXCHANGES



- An exchange is no longer an actual “swap”.
- It is sale and purchase with very little difference than a non-1031 transaction.
- Exchange documents create the transaction.
- The gain from the relinquished property is deferred into the replacement property.

IRC §1031 TAX DEFERRED EXCHANGES

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.

Deferral of tax, NOT a tax free transaction.

LIKE KIND – REAL PROPERTY

LIKE KIND PROPERTY



LIKE KIND – REAL PROPERTY

INTENT

Intent: actions over a period of time.

LIKE KIND

Held for productive use in a trade or business.

or

Held for investment purposes.

RULES TO OBTAIN A COMPLETE DEFERAL

- Purchase replacement property of equal or greater value to the relinquished property.
- Reinvest all of the net proceeds from the relinquished sale into the replacement property purchase.
- Obtain equal or greater financing on the replacement property as was paid off on the relinquished property.
- Receive nothing except like-kind property.

DELAYED EXCHANGE STRUCTURE



IDENTIFICATION RULES

THREE PROPERTY RULE

- Exchanger may identify up to three properties regardless of value.

200% RULE

- Exchanger can identify an unlimited number of properties, provided that the total value of the properties identified does not exceed 200% of the value of all relinquished properties.

95% EXCEPTION

- If Exchanger identifies more than three properties which are worth more than 200% of the value of all relinquished properties than Exchanger must acquire 95% of the value of all properties identified.

PROCEDURE FOR PROPER IDENTIFICATION

- Identification must be made in writing.
- Unambiguously describe the property.
- Signed and dated by the taxpayer.
- Received by midnight of the 45th day or postmarked by the 45th day.
- Delivered to Exchanger's Qualified Intermediary or to a party related to the exchange who is not a disqualified person.

EXCHANGE VESTING ISSUES

- With very limited exception, the person or entity who relinquishes property must be the same person or entity to buy the replacement property.
- A good rule of thumb is that you must have the same tax identification number on both sides of the transaction.

IRC §453 - INSTALLMENT SALES AND STRUCTURED INSTALLMENT SALES

INSTALLMENT NOTE TREATMENT

- IRC §453 provides that to the extent a taxpayer does not receive consideration from a sale they are not taxed on the amount outstanding.
- An installment sale occurs when the taxpayer receives at least one payment after the close of the taxable year in which the sale or exchange occurs. IRC §453(b)(1)
- Installment sales may not be used to defer the recognition of a loss. A loss must be reported in the year of the sale. Rev. Rul. 70-430.
- Installment sale treatment may not be used by dealers of real or personal property. IRC §453(b)(2)

INSTALLMENT NOTE TREATMENT

- In order to figure out what portion of an installment note payment is taxable the taxpayer must determine the gross profit percentage.
- GROSS PROFIT PERCENTAGE – the ratio of the gross profit realized to the contract price. IRC §453(c)
- If part of the gain recognized is from unrecaptured IRC §1250 depreciation the taxable portion of the gain received is paid first at the higher depreciation recapture rate. (For sales after August 23, 1999) Reg. §1.453-12
- Certain depreciation methods can cause the recapture to be reclassified as ordinary income and not treated as an installment sale. (e.g. – ACRS commercial real property depreciated using accelerated depreciation instead of straight line.)
- If a buyer assumes a mortgage liability in excess of the basis of the sale property the difference is considered a payment in the first year. IRC §453(f)(3)

DETERMINING GROSS PROFIT PERCENTAGE

1st Calculation: Realized Gain

Sale Price	\$800,000
Less: Adjusted Basis	- 100,000
Less: Selling Expenses	- 40,000
Equals: Gross Profit to be realized	\$660,000

2nd Calculation: Contract Price

Selling Price	\$800,000
Less: Assumed Mortgage	- 0
Equals: Contract Price	\$800,000

3rd Calculation: Gross Profit Percentage

Realized Gain (1 st Calculation)	\$660,000
Divided By: Contract Price (2 nd Calculation)	\$800,000

Gross Profit Percentage	0.825 or 82½%
--------------------------------	----------------------



DETERMINING GAIN USING GROSS PROFIT PERCENTAGE

ASSUMPTIONS

Sale Price: \$800,000, 1st Year Down Payment: \$200,000, \$60,000 per year for 10 years.
Basis \$150,000 - \$50,000 depreciation = \$100,000 Adjusted Basis

1st Calculation: First Year Down Payment

Down Payment	\$200,000
Multiply: Gross Profit Percentage	x 82.5%
<u>Taxable Gain</u>	<u>\$165,000</u>
Multiply: \$50,000 x 25% Depreciation Recapture	\$12,500
Multiply: \$115,000 x 15% Capital Gain Tax	\$17,250
Equals: Tax Due on First Year Down Payment	\$29,750

2nd Calculation: Subsequent Year Payments

Installment Payment	\$60,000
Multiply: Gross Profit Percentage	x 82.5%
<u>Taxable Gain</u>	<u>\$49,500</u>
Multiply: \$49,500 x 15% Capital Gain Tax	\$7,425
Equals: Tax Due on Each Installment Payment	\$7,425



STRUCTURED INSTALLMENT SALES

- Structured Installment Sales are considered an alternative to an IRC §1031 tax deferred exchange.
- If a seller takes back a note from a buyer to obtain installment note treatment they have to be concerned with the buyer's ability to pay.
- Structured Installment Sale does away with that risk.
- Proceeds from sale are invested and seller receives a note secured by the investments.
- Seller benefits by receiving income on the deferred taxes as opposed to only receiving income from after tax dollars in a straight sale.

STRUCTURED INSTALLMENT SALES

- With a structured installment sale the seller assigns the sale contract to a third party company in return for an installment note. IRC §453
- The third party company receives the net proceeds from the sale.
- The net proceeds are used to purchase an annuity (normally from a life insurance company).
- In return the third party company structures an installment note in favor of seller. Payments consist of return of basis (which is not taxed), gross profit (taxed at 25% depreciation recapture and 15% capital gain tax rate), and ordinary income derived from annuity investment.

DEFERRED SALES TRUST

- A Deferred Sales Trust™ is a trade name for a type of structured installment sale pursuant to IRC §453.
- A DST provides for more flexibility than a structured installment sale.
- Instead of purchasing an annuity with the proceeds collected, the funds are placed in a trust account and invested pursuant to risk tolerances dictated by seller during the formation of the trust.
- Proceeds can be invested in stocks, bonds, mutual funds, real estate (eg. REITs), annuities, and many other types of financial products.
- Investor can obtain a tax free loan against the income of the note.



BENEFITS OF A STRUCTURED INSTALLMENT SALE OR DEFERRED SALES TRUST (DST)

- | | |
|---|--|
| <ul style="list-style-type: none">• Original Purchase Price: \$4,800,000• Sale Price: \$8,000,000• Mortgage Payoff: \$2,400,000• Gain Due to Appreciation: \$3,200,000• Depreciation: \$400,000 | <p>15% Federal and 8% State taxes:
Taxable Gain: \$3,600,000.
(Capital Gain: \$3,200,000 and
Depreciation: \$400,000)
Tax Due Upon Sale: \$868,000</p> |
|---|--|

Taxable Transaction: Sales proceeds after taxes paid: \$4,732,000
Earn 8% Annual Interest Income of \$378,560

DST Transaction: Taxes deferred, sales proceeds is: \$5,600,000
Earn 8% Annual Interest Income of \$448,000

DST Income difference is 15.5% or \$69,440 per year!





REPLACEMENT PROPERTY STRATEGIES



MAXIMIZING A 1031 IDENTIFICATION

- Common mistake: Identifying only one property within the 45 day identification period Risk. If unable to close on the primary property after the expiration of the 45 days the exchange will fail.
- Solution: Utilizing either the 3 property rule or the 200% rule, identify 3 or more properties to provide a backup property(s) in case the primary property cannot be purchased
- Additional strategy: Purchasing multiple properties that in the aggregate will complete the equity and financing requirements. One or more properties can be purchased primarily to absorb the residual equity or financing needed to avoid a tax liability. (i.e. - Zero-Coupon below)



REPLACEMENT PROPERTY OPTIONS

TRIPLE NET LEASE PROPERTY

- Deeded interest in a property where the tenant is responsible for most or all of the costs (insurance, taxes, maintenance).
- Typically a company develops a location, sells it to an investor, and takes back a long term lease.
- Examples: CVS, Advance Auto, Home Depot, 7-11.
- Credit of the tenant and time left on a lease can have an effect on the investment's return and subsequent sale price.
- Attractive to investors because they have no day to day responsibility for the property.
- Most net lease properties are priced at \$1M+.



REPLACEMENT PROPERTY OPTIONS

TENANT IN COMMON (TIC) AND DST PROPERTIES

- Undivided fractional co-ownership of real estate between two or more people.
- Separate deeds for each undivided interest.
- Generally, most tenant-in-common ("TIC") and DST programs are treated as real estate for exchange purposes and securities for sales purposes. Buyer must be an accredited investor.
- Flexible investment amounts as low as \$50,000.
- Non-recourse assumable financing available.
- Professional property management provided.
- Certainty of closure once a client has been approved.



ZERO COUPON STRATEGY

- In order to complete an IRC §1031 the taxpayer must take out an equal amount of debt on the replacement property as was paid off on the relinquished property.
- Strategy can also be used for an IRC §1033 condemnation to purchase property of equal or greater value to the net proceeds received.
- Net lease property with a credit tenant (such as CVS or Walgreens), and a long term lease, can be purchased with assumable non-recourse financing up to 90% loan to value.
- Can be purchased with as little as 10% - 13% equity investment.
- Useful for exchangers where their property value has retreated leaving them with highly leveraged property.
- Can be used as a strategy to free up exchange equity for other replacement property purchases.



ZERO COUPON STRATEGY FOR PROPERTY WITH LOW EQUITY

The following example demonstrates the tax implications for a property that is "under water":

Net Sale Price		\$8,000,000
Debt	81%	\$6,500,000
Equity	19%	\$1,500,000
Basis		\$1,000,000
Gain		\$7,000,000

Net Proceeds from Sale	\$1,500,000
Taxes Due	<u>-\$2,100,000</u>
Cash Received After Tax	<u>-\$600,000</u>

Taxpayer needs to come out of pocket!



ZERO COUPON STRATEGY TO ABSORB DEBT FOR A 1031 OR 1033 EXCHANGE

Net Sale Price		\$8,000,000
Debt	81%	\$6,500,000
Equity	19%	\$1,500,000
Basis		\$1,000,000
Gain		\$7,000,000

Rep #1 - NNN Property

Purchase Price		\$5,000,000
Debt	90%	\$4,500,000
Equity	10%	\$500,000

or 1031

Net Proceeds from Sale	\$1,500,000
Taxes Due	<u>-\$2,100,000</u>
Cash Received After Tax	<u>-\$600,000</u>

Rep #2 - TBD

Purchase Price		\$3,000,000
Debt	67%	\$2,000,000
Equity	33%	\$1,000,000



ZERO COUPON STRATEGY – CASH OUT REFINANCE

Net Sale Price		\$5,000,000
Debt	0%	\$0
Equity	100%	\$5,000,000
Basis		\$1,000,000
Gain		\$4,000,000

Rep #1 - NNN Property

Purchase Price	\$5,000,000
Debt	\$0
Equity	\$5,000,000

Net Proceeds from Sale	\$5,000,000
Taxes Due	<u>-\$1,200,000</u>
Cash Received After Tax	<u>\$3,800,000</u>

Re-Finance Proceeds

Cash Received	\$4,250,000
---------------	-------------



LEGAL NOTICE

Legal 1031 Exchange Services, Inc. and Real Estate Tax Strategies, Inc. are not able to provide tax or legal advice, nor can they make any representations or warranties regarding the tax consequences of your transaction. Property owners must consult their tax and/or legal advisors for this information.

Circular 230 Disclosure: Pursuant to recently enacted U.S. Treasury Regulations, we are now required to advise you that, unless otherwise expressly indicated, any perceived federal tax advice contained in this communication, including attachments and enclosures, is not intended or written to be used, and may not be used, for the purpose of (i) avoiding tax-related penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any tax-related matters addressed herein.

Legal 1031 Exchange Services, Inc. and Real Estate Tax Strategies, Inc. are separate unrelated companies.



THANK YOU FOR
ATTENDING!



877/701-1031

877/703-1031

www.legal1031.com

todd@legal1031.com