



Breaking News in the Real Estate Industry

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2007 Exchange Trends⁽¹⁾

Grisenia Matos
President

In the first quarter of 2008, Deloitte Tax LLP completed a study outlining current trends in the 1031 exchange industry. The study was based from data collected from: a Deloitte tax survey of

qualified intermediaries (i.e., the unrelated entities who participate in capital gains tax-deferred, like-kind exchange to facilitate the disposition of the relinquished property and acquisition of the replacement property); the Internal Revenue Service's (IRS) sampling of 1998-2005 Form 8824 filings (i.e., the IRS form utilized by a taxpayer reporting a completed capital gains tax-deferred transaction); and tenant-in-common transactional data collected by OMNI Consulting and Research. Though the 2007 results⁽²⁾ reflect preliminary data and are pending further review, the preliminary results have confirmed the many rumblings of qualified intermediaries the writer of this article has heard the past year: nationally, exchanges were down a whopping -43.19% in 2007. Ouch!

Exchange participants were divided into three major categories: corporations, partnerships and individuals. In 2007, preliminary data indicated individuals accounted for the majority of exchanges (about 70K), followed by corporations (about 64K) and partnerships (about 30K). However, when looking at the exchange dollar volume, partnerships exchanged larger dollar volumes (about \$61B) followed by corporations (about \$46B) and individuals (about \$44B).

In 2007, the average deferred gain per transaction for each of these categories had exceeded each of the preceding years. The highest deferred gains were reported by partnerships at a little bit over \$1M, while corporations' average deferral were about \$360K and \$220K for individuals.

Three observations in the study bear mention: (1) nearly all QIs surveyed reported that 45% of their exchanges represent transactions with equity of less than \$500K; (2) the dip in the frequency of exchanges completed during 2007 was compensated by larger exchanges; and (3) 10% of initiated deferred exchanges failed.

⁽¹⁾ Deloitte Tax LLP, San Francisco, CA

⁽²⁾ The study assumes that the qualified intermediary data represented approximately 12% of exchanges.

Know Your Numbers Before Exchanging

My telephone rang about 10 days ago. An investor seeking to complete an exchange had been referred to me by one of my business contacts. It appeared that he was in the process of negotiating a contract on one of his investment properties and wanted to defer the capital gains taxes on the sale of this property. He was searching for replacement property and needed assistance with his search.

"Have you consulted with your tax advisor," I asked during the conversation. "No," he responded. <<Not unusual,>> I thought, as the majority of investors I have come in contact with wait to talk to their tax advisors either during or after the sale of their relinquished property.

After an hour and a half of answering some basic exchange questions, I informed him that I would best serve his needs in determining if an exchange was appropriate for him and the type of investment that would match his needs if he would obtain more specific information from his tax advisor. The information included: the dollar amount of capital improvements, the total depreciation deducted over the years, the balance on the note, the terms of the existing contract (was any personal property included in the sale), financing, etc.

Four days later he contacted me. <<That was quick,>> I thought. He confirmed what I had suspected during the preliminary visit—the capital gain to be deferred would be higher than he anticipated. The 15% capital gains tax liability he thought he was to pay had approached over 30%.

It is not unusual that investment properties held for more than 30 years have other taxes that may potentially come into play and increase the tax liability on the sale even higher than the 30% of the gain noted above.

Calculating the gains and tax liability on the sale of the property is based on the adjusted basis of the property. Adjusted basis is the original purchase price and cost, plus capital improvements, minus depreciation. The adjusted basis is then subtracted from the current sales prices and the current cost of sales. The result is the gain. The tax liability on the sale of real property is based on two taxes—15% tax calculated on the gain, and a 25% tax calculated on the depreciation taken during the holding period by the taxpayer.

Other taxes may potentially apply. For example, if an investor converts ownership of his property from a C corporation to an S corporation—an additional corporate tax rate of 35% is applied only to the gain of the property as calculated on the conversion date. The 35% rate is effective for 10 years from the conversation date.

Some states levy state capital gains taxes. Taxpayers should also remember that based on the holding period, the type of property held for investment, and the type of depreciation method utilized, additional excess depreciation recapture taxes may be incurred and are taxed at the ordinary income tax rate of the taxpayer. One final note: if the capital gain, recapture depreciation and excess depreciation are large enough, the sale of the property may trigger alternative minimum tax issues. And the taxes continue . . .

Lastly, if one objective of selling the property is to optimize the 100% deferral of the taxes due, the taxpayer should include as part of his/her search criteria property that matches or exceeds the loan-to-value ratio of the relinquished property and its depreciation schedule.

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The Gift of Giving

Most people aspire to live life to the fullest, be surrounded by and be in love, learn as much as possible, and leave a legacy to family, children, friends and the community. Of the four, leaving a legacy usually proves the most challenging. What legacy to leave? How much time and energy to devote to creating and leaving the legacy? How about the continuity factor of the legacy—management, intent, funding, and other issues?

The Life Income Fund of America has created a tax-efficient exit strategy from appreciated real estate that addresses the questions raised above. Investors may donate their appreciated real estate to their recommended non-profit organizations or choose from a pre-selected giving portfolio, eliminate capital gains taxes, receive a charitable contribution for the tax donation on the year of the contribution, generate lifetime income, reduce estate taxes for their heirs, and eliminate the property management hassles. There are restrictions: (1) all potential real estate is subject to review and approval; (2) donors must have owned the real estate for longer than one year; (3) the minimum acceptable contribution is \$150,000; and (4) Life Income manages the disposition of real estate contributions to ensure that the parameters of Internal Revenue Code Section 642(c)(5) are met.

For more details on creating your legacy through Life Income, please contact Grisenia Matos at 214-850-1144.

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From the desk of:

Grisenia Matos, MBA

President—Broker/Realtor®
Registered Representative—Welton Street Investments

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Questions or comments? E-mail us at Grisenia@weltonstreet.com or 1-888-868-1031.

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