THE TAX-FREE EXCHANGE LOOPHOLE

How Real Estate Investors Can Profit from the 1031 Exchange

- 1031 explained in easy language
- Tips on negotiating a tax-exchange offer
- 10 creative techniques applied to exchanges

JACK CUMMINGS

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To Kassandra and Sebastian,
United in the Search of World Peace

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Tax-free exchanges offer a passage to greater wealth that is open to everyone in the United States, but is used only by those who know it exists, and how to take advantage of it.

The greatest real estate investment tool known to mankind is called a “tax-free exchange.” In the Internal Revenue Code it is simply called IRC Section 1031. It works its magic in such a way that, when properly used, an investor need never pay capital gains tax on his or her real estate investment profits. That’s right. Roll the capital right back into another investment without paying capital gains tax—ever. And you can roll it over and over again.

A tax-free exchange, as IRC Section 1031 is called, is, in essence, a loan to you that you don’t pay any interest on and which you never have to repay (if you play your cards correctly). This book not only shows you how to play those cards properly, but it demonstrates to you in easy-to-follow steps how to multiply the effect of the tax-free exchange over and over. Best of all, this book uncovers the secrets that the insiders keep to themselves; it shows you how you can legally use this loophole to make a sale and not pay any capital gains tax at all, ever, no matter how much you actually make—exchange or not.

Financial Independence Is Just around the Corner

This book will give your journey toward financial independence a tremendous boost. By elevating you into the ranks of real estate insiders, it gives you a working knowledge of not only IRC Section 1031 tax-free exchanges, but also how the technique of real estate exchanging can give you the edge in real estate investing no matter whether the market is hot or has grown cold. Investment potential at its greatest level is attained by using all the tax and legal advantages the laws allow.

Of all the investments you can make, the most productive commodity is real estate. Ask Donald Trump, Warren Buffett, and even George W. Bush if you have any doubts about this. Real estate is it—simply it. You can't add it to a sold-out subdivision, you can't create it on the already built-up oceanfront of Miami, or Saint-Tropez, or wherever people want to be. Best of all, real estate is an item that you can easily control and master. It is local, so much so that perhaps it is the office building or hotel just down the street from where you live that supports your family with jobs, wages, and a financially independent life. Real estate can ensure that you are in control of your future.

Real estate is a solid investment that is not volatile or subject to the whims of the stock market, and, thanks to the current financial market, it is affordable and can be acquired with a down payment that is just a fraction of its real value. Sometimes it can be purchased with nothing more than a promise to pay. Take these benefits and tie them to the greatest investment tool known to mankind and your financial future will take off like a rocket to the moon. Or even further.

There's Magic in Real Estate

All real estate insiders know that there is much that is magical about real estate. From a wealth-building point of view, real estate receives special treatment by the IRS that, if you know the loopholes, gives the real estate investor the edge over everyone else.

That's right, there are several great loopholes that the IRS hands out to real estate investors, only not all these investors are standing in line to receive them. Not everyone knows all the loopholes that exist, or how to use them to their maximum potential. And sadly, many investors, lawyers, and accountants are shy about using the real estate investment tool known as the tax-free exchange. Why? Because they don't fully understand the rules. When lawyers or accountants do not fully understand something, do you think they will advise their clients to use it? Absolutely not. That's bad news for you, if you are their client. The good news is this book and the greatest real estate tool it exposes.

This book tackles this subject in an easy-to-follow way. It is filled with my own personal portfolio examples, my own painful experiences

(to save you from those pitfalls), and many rewards that just keep on giving. Easy-to-follow and smart-to-use checklists turn the IRC 1031 into a good friend—that is, a good moneymaking friend.

The book builds your knowledge as you go. Each chapter opens with the goals of that chapter, and is followed by a section titled "Terms and Concepts You Need to Know." These are the building blocks of each chapter and set the stage for the walls and roof of that structure to follow.

Through the many real-life examples you can discover what you need to do to avoid making mistakes in using this tool.

I invite you to share your exchange potentials and questions with me via e-mail at jwcre@aol.com.

CHAPTER 1

How to Use This Book to Maximize Your Real Estate Investment Profits

The goal of this chapter is:

To Set the Stage So You Get the Most from This Book

This book is written in a building-blocks style. Each element will not only help you understand the information, but also enable you to use one set of data to better understand the next to follow. This will help you in many other ways, too.

First, this building-block method speeds up the whole process of becoming a real estate insider. Second, it gives you the terms and concepts that insiders use, and enables you to quickly begin to use those terms. Third, you will see concepts that most of the professional people in real estate, including some accountants and lawyers, only vaguely understand and therefore tend to shy away from. The worst part of that scenario is that when accountants or lawyers are not comfortable with a concept,

they rarely want to acknowledge that fact, and instead of owning up to their lack of knowledge they might just say, “You had better stay away from that.”

Each chapter of this book begins with the goal to which the chapter is dedicated. That does not mean that is the end of the involvement with that subject; it is simply the main goal of that chapter. Once the goal has been stated, each chapter follows with a heading “Terms and Concepts You Need to Know.” You may already know many or even most of them, but do not rush through the text that defines and discusses them. Why? Simply this, the terms and concepts take you into other areas of real estate investing that may be new to you. You may know the term in an entirely different context, and not realize its significance as it pertains to Internal Revenue Code (IRC) Section 1031 exchanges or other features of the tax code that this book will introduce to you.

The goal of this **book** is:

To Improve Your Real Estate Investing Opportunities through Exchanging

This easy-to-read book deals with the various forms of real estate exchanges. You will discover the mechanics of creative financing and insider techniques of how to successfully complete many types of exchanges. Some of these techniques will save you money you would have had to pay to Uncle Sam (the IRS). Other techniques show you how to buy or sell real estate more profitably by putting the word *exchange* into the equation. Still others will help you fine-tune your ability to expand your knowledge of the Starker exchange and other tax-free kinds of exchanges that have become some of the biggest events in the real estate world.

Terms and Concepts You Need to Know

Pretax Investment Value
Boot Paid or Received
Tax Basis
Net Operating Income
Amortization
Balloon Mortgage
Estate Taxes
Planning and Zoning
Comfort Zone

Let's review each of these terms or concepts in detail.

Pretax Investment Value

The concept of pretax investment value is simple enough. In the context of real estate investing it is the value of the assets you give up when you purchase a property. In essence, if you use cash and/or other assets, what will that cash and/or other assets cost you at the end of the year in the way of tax? If there is no added cost in the transaction, the amount you spend (the pretax cost) will equal the after-tax cost. If, however, you have to reach into your pocket and pay an additional sum of money in tax, the after-tax cost will exceed the pretax cost.

The tax in question is the tax on any gain to you at the time of a sale. Keep in mind that I am talking about a gain as a result of a sale as calculated by the Internal Revenue Service (IRS). You will soon discover that if you take depreciation on a property, the amount of the depreciation taken is recovered as a gain when you sell. So, it is possible to sell at the same price you paid for a property and still have a taxable gain. Here is an example of what I mean:

Brad's Transaction

Brad is a manager of a local department store. He makes good money, which is a combination of his salary and annual bonus for exceeding his

projected level of sales. Let's say that at the end of the year he sees that he will receive an unexpected annual bonus of $50,000. He wants to invest that as a down payment on a small apartment building he has had his eye on for several months. It is for sale at a bargain price of $220,000 with the seller holding all the financing. The apartment building is in need of repair and cosmetics, which Brad feels he will be able to do working weekends over the next 18 months at a cost of around $30,000 for the material (he will do all the labor). His total price, he figures, will be $250,000. But Brad has forgotten that he will have to pay income tax on the $50,000 bonus, which at his (overall) 20 percent bracket would cost him another $10,000 and bring his overall cost to $260,000.

But wait, Brad owns a residential lot in North Carolina that is worth $60,000. He thinks about it, and decides that as he is never going to build on the lot, why not see if he can put it into a deal with the owner of the apartment building? If he offered the seller of the apartment building the $60,000 lot and all cash for the balance, he would owe $160,000 ($220,000 less the lot's value of $60,000). The seller might be motivated enough, now that he is getting a big block of cash, to take the lot and perhaps even lower the price on the apartment building. Now Brad can take his cash, even as much as $40,000 of his $50,000 bonus, and plug it into the building by hiring a contractor to do the needed work right after closing, so that he can get the benefits of the work right away. If the work was mostly repair and fix-up, Brad may be able to take advantage of a tax write-off of the expense and end up having a much lower tax base, and now a year-end income tax on only $10,000 (his $50,000 of earnings less $40,000 repair expense). This reduction in his taxable income for that year may have an added bonus by lowering his income to a level that would also reduce his overall tax rate.

However, the nicest part of this transaction is yet to come. He ties up the property with a firm contract that gives him access to the property prior to the closing to do the fix-up work. If properly structured, the contract to acquire the building creates several win-win benefits for both parties. The owner of the apartments would like the fact that Brad is spending money on a building he doesn't own yet, while at the same time it speeds up Brad's overall process to improve the building so that he can raise rents the moment he takes title. Perhaps best of all, the added improvements and newly projected rents will increase the value of the property and boost the lending value to the extent that a new lender will see

the building in a new light. It will no longer be a fixer-upper; it will be an apartment building with a fresh new look, with fresh new rents predictable. The value of the newly fixed up building might be $285,000 or even more. Using this new value Brad should be able to borrow as much as $228,000 as that would represent only 80 percent of the new value.

What does Brad's deal look like now? Well, his total investment cost is the $220,000 price on the apartment building (unless he could now get it for less due to the cash paid to the seller), plus the cost of the work that goes into the building of $40,000. So we can say that his cost is $260,000. What does he actually pay from his pocket? Well, he borrows $228,000, which might cost him $3,000 in loan costs so he nets out $225,000. As he has to give the seller only $160,000 of that (plus his $60,000 lot), he still has $65,000 left. Brad pays for the work to the building with his earnings, because remember, that work is done prior to closing on the apartment building. But he adds the leftover $65,000 from the loan to the remaining $10,000 in the bank. Of the $75,000 now in the bank, only the $10,000 left over from the repair cost is taxable.

Recap of Brad's Deal So Far

Price of apartments	$220,000	
Repair and fix-up cost	40,000	(Paid for by Brad prior to closing)
Total Brad will have invested	$260,000	
Brad gives owner North Carolina lot	$ 60,000	(This occurs at the closing)
	$200,000	
Less repair and fix-up cost	40,000	(Already paid by Brad)
Cash Brad owes the owner	$160,000	
Brad borrows	$228,000	
Less cost of mortgage	3,000	
Net proceeds of loan	$225,000	
Less what Brad still owes	160,000	
Tax-free cash left over	$ 65,000	

Plus cash still in bank	10,000	($50,000 less repairs of $40,000)
New bank balance	$75,000	

How did Brad end up with $65,000 tax-free cash? Because $65,000 he borrowed is not taxable at this time, if ever. Brad started out with only $50,000 and an unproductive lot in North Carolina. He ends up with $75,000 cash in the bank and is the proud owner of a freshly fixed up apartment building. As the North Carolina lot was owned as a long-term investment, he didn't have to pay any capital gains tax on the transfer of that lot to the seller of the apartments. Brad can start looking for another real estate investment because he took a hard look at what his real cost would be (the after-tax cost), and by applying some creative techniques he leveraged his assets to greatly improve his situation.

Brad's transaction is a simple example of using the exchange process to improve his overall situation. He has accomplished several positive steps in maximizing his investment potential. He has gotten rid of an asset that was not doing much, if anything, for his investment future; maximized his new loan opportunity by borrowing on a building already fixed up; and took advantage of bringing in tax-free capital from the proceeds of the loan. This is just one way in which the tax code can benefit you just as it did Brad. As we move further into exchanging, and in particular using the IRC Section 1031 tax-free exchange, you should keep focused on the fact that not all exchanges involve a one-on-one exchange like the one accomplished by Brad. Also, exchanges can include other elements besides real estate. When a non–real estate or a nonqualified type of real estate is used in the exchange, that part of the deal may become taxable to the party receiving it. These elements are called boot.

Boot Paid or Received

Although the term *boot* does not show up in the tax code, its use is accepted to mean cash or other assets that do not qualify for Section 1031 status. In essence, if you give me real estate worth $100,000 and I give you real estate worth $80,000 and to sweeten the deal I throw in $5,000 cash, a diamond ring worth $5,000, and a personal note to pay you the

balance of $10,000, then you have received $20,000 of boot. In this example that entire amount of $20,000 in value is subject to being taxed, provided that your gain was at least $20,000.

In many real estate exchanges both sides may give and take nonqualifying values in the exchange. Here is what a deal might look like.

You Get from Me	*You Give Me*
A condominium worth $80,000	A vacant lot worth $100,000
A sailboat worth $30,000	Cash in the amount of $10,000

The net effect for you in the boot transfer is $20,000. You took from me a sailboat worth $30,000 but had to pay me $10,000 to balance the equities. Still, if your gain equals $20,000 then that becomes taxable. If your gain (in the lot) is only $15,000 you will owe tax only on that amount.

Many real estate exchanges include the transfer of some cash and/or other nonqualifying assets. These assets can be other real estate that would not meet the test for 1031 treatment (say, real estate that is not in the United States or an investment that would become inventory for resale or is clearly not a like-kind property according to the IRS). All of these assets would be taxable by the party that receives them up to the extent of the gain that is present on the property given up by that person.

In the closing of the exchange, boot is a netted-out factor. By this I mean that the IRS allows a party to receive boot in the transaction, but if that party pays (or gives) to the other party boot, the two amounts can cancel each other out. In some situations each party receives taxable boot, and if one party has received more boot than he or she has given to the other party, there could be a tax due on that overage. But in no event will the taxable boot be greater than the actual gain on which the taxpayer would have had to pay tax in the first instance. If one party receives excess boot but that party has no taxable gain, then the question of tax to that party is moot and a nonissue.

Eight Causes of Boot

In the calculations of boot, there are a number of factors to take into consideration. Overlooking any of these elements can result in a surprising

tax consequence at the closing when none was anticipated. Let's look at the eight most obvious causes for boot.

Cash Received: If money changes hands, then this is boot. To the extent that all boot that is given and received is added up and netted between the parties, the act of giving or receiving boot is not the final determination of whether there is a tax to be paid, and if so which side will be obliged to pay it. In the netting of boot, several factors must be considered.

1. Cash boot that is paid always offsets cash boot received.
2. Cash boot paid to the owner of the replacement property also offsets mortgage relief given up by the owner of the exchanged property.
3. Net cash received from the replacement owner is not offset by debt assumed (on the replacement property). Any net cash to the tax-payer taking the replacement property will be taxable (if there is a taxable gain).

Net Debt Relief: As the IRS considers that if you are relieved of a debt obligation in the deal, such as a mortgage against the property you are giving up, then that is treated as though you have been given cash in the amount of the mortgage you no longer have to pay. Remember, you got the benefit of that mortgage at the time you purchased the property, or you received cash when you refinanced the mortgage some time ago. Now you may have to pay the piper (Uncle Sam). But as boot is netted out between the parties, if you are relieved of a mortgage, say $500,000 in the property you give up, but assume a $501,000 (or larger) mortgage on the property you get and there are no other boot items to upset this balance, you are clear of tax on the boot issue. The extra amount that you are obligated to, in this case $1,000 (or more), will increase your tax basis by that amount. But let's not get ahead of ourselves.

Closing Service Cost: If the closing agent dips into the 1031 escrowed funds to cover certain costs that would not be qualified acquisition costs, such as cost of a survey or title insurance, those funds could be treated as boot. This should not be a problem, and one way to ensure that does not happen is to question every debit and credit on the closing statement. If