Investment Property Exchange Services, Inc.

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INSIGHT ▪ INNOVATION ▪ EXPERIENCE

USING 1031 TAX STRATEGIES TO DEFER CAPITAL GAINS IN 2011

- **Scott Nathanson, Vice President and Regional Manager**
  IPX 1031, Investment Property Exchange Services, Inc.

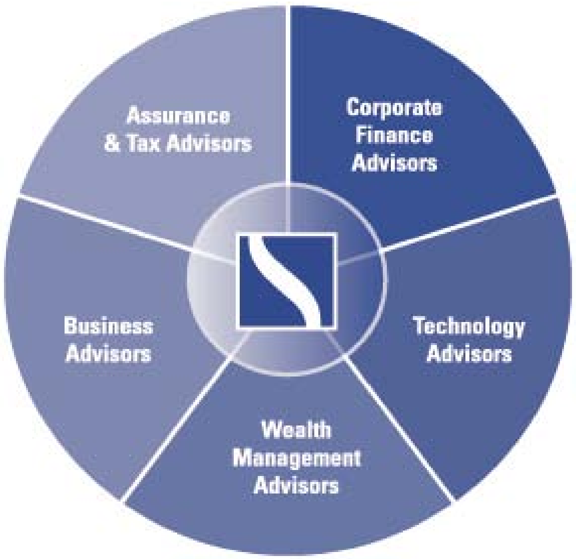
- **Pierre W. Priestley, Vice President and Division Manager**
  IPX 1031, Investment Property Exchange Services, Inc.

- **Gennaro J. DiBello, Shareholder**
  Schneider Downs

April 26, 2011

Schneider Downs Profile

- Founded in 1956
- Offices in Pittsburgh, PA and Columbus, OH
- Approximately 330 personnel and 32 Shareholders
- One of the 60 largest certified public accounting firm in the U.S. (AICPA Major Firms Division)
- Fourth-largest certified public accounting firm in Western Pennsylvania
- Registered with the PCAOB
- Founding member of IGAF Polaris (1979)



Providing over 75 services from the Schneider Downs group of companies.

Schneider Downs Major Service Offerings

Audit	Traditional	Internal Audit
	SEC	ERISA
Tax	Traditional	Employee Benefits
	International	Cost Segregation
	State and Local Tax	Co-sourcing/Outsourcing
	Tax Accounting/Fin 48	Executive Tax Planning
Business Advisors	Productivity Improvement	Technology
	Process Engineering	Forensic Accounting/Litigation Support
	Business Valuation	Transaction Advisory Services
Wealth Management	401 (k) Plan Management	High Net Worth
Corporate Finance	Merger & Acquisition	Corporate Finance
	Buy Side	Sell Side
Creative Financial Staffing	Permanent	Temporary
Technology	Software Solutions	Software Selection
	Process Re-engineering	Internal Control Assessment
	Security Vulnerability	Review of Ongoing Technology Operations

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§1031 EXCHANGE HOT TOPICS

PRESENTED BY:

SCOTT NATHANSON, VP and REGIONAL MANAGER

PIERRE W. PRIESTLEY, VP and DIVISION MANAGER

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AGENDA

- Basic §1031 Guidelines
- Personal Property
- Combining Section 1031 and 121
- Vacation Homes and Second Homes
- Installment Sales
- Partnership Issues
- Security of Exchange Funds

BACK TO THE BASICS

DEFINITION:

A §1031 exchange is a simple transaction that allows taxpayers to **defer** paying **capital gains tax** on the sale of investment property by purchasing a new piece of **like kind** investment property in a specific time frame.

WHY DO SELLERS PARTICIPATE IN A §1031 EXCHANGE?

- Taxpayers use §1031 to maintain their investment and increase the value of their portfolios
- Defer capital gains tax as well as depreciation recapture tax
- Dramatically increase purchasing power
- Possibility of completely avoiding capital gains and recapture depreciation tax – "swap till you drop"

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WHAT TYPES OF PROPERTIES CAN BE EXCHANGED?

EXCHANGEABLE

- **Real Estate**
  - Held in Land Trusts
  - TIC
  - Leasehold Interest
- Mineral rights, Air rights, Oil and Gas royalties
- Aircraft
- Railcar
- Artwork
- Franchise rights

NOT-EXCHANGEBALE

- Property held primarily for sale
- Stocks, Bonds, Notes
- Interests in a partnership
- Choses In Action
- Money, Cash or Cash Equivalents
- Certificates of Trust or Beneficial Interest
- Other Securities or Evidence of Indebtness or Interest
- Primary Residence

§1031 GUIDELINES

<u>IN ORDER TO HAVE A SUCCESSFUL EXCHANGE THE TAXPAYER SHOULD:</u>

1. Purchase property that is equal to or more in value to the property that was sold
2. Reinvest all of the net proceeds from the sale into the new property
3. Purchase property in the same name that the old property was sold in
4. Purchase property that is <u>like kind</u> to the property that was sold (real estate for real estate)
5. Adhere to the §1031 Time Requirements
   - 45 Identification Period
   - 180 Day Exchange Period

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TIME PERIODS

- The taxpayer has 45 days from the sale to identify new property to purchase:
  - 3 PROPERTY RULE
  - 200% RULE
  - 95% RULE property

- The taxpayer typically has 180* days to purchase one or more of the identified properties.

** Unless the due date of the exchanger's tax return occurs prior to the 180th day*

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WHAT IS PERSONAL PROPERTY

- All property – tangible and intangible - that is <u>not</u> real property
- Sale results in a tax gain:
  - Recapture of Depreciation
  - Capital Gain from appreciation in value
- Productive use in a trade or business or held for investment

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PERSONAL vs REAL PROPERTY

THE MAIN DIFFERENCE BETWEEEN PERSONAL AND REAL PROPERTY EXCHANGES IS THE LIKE KIND REQUIREMENT

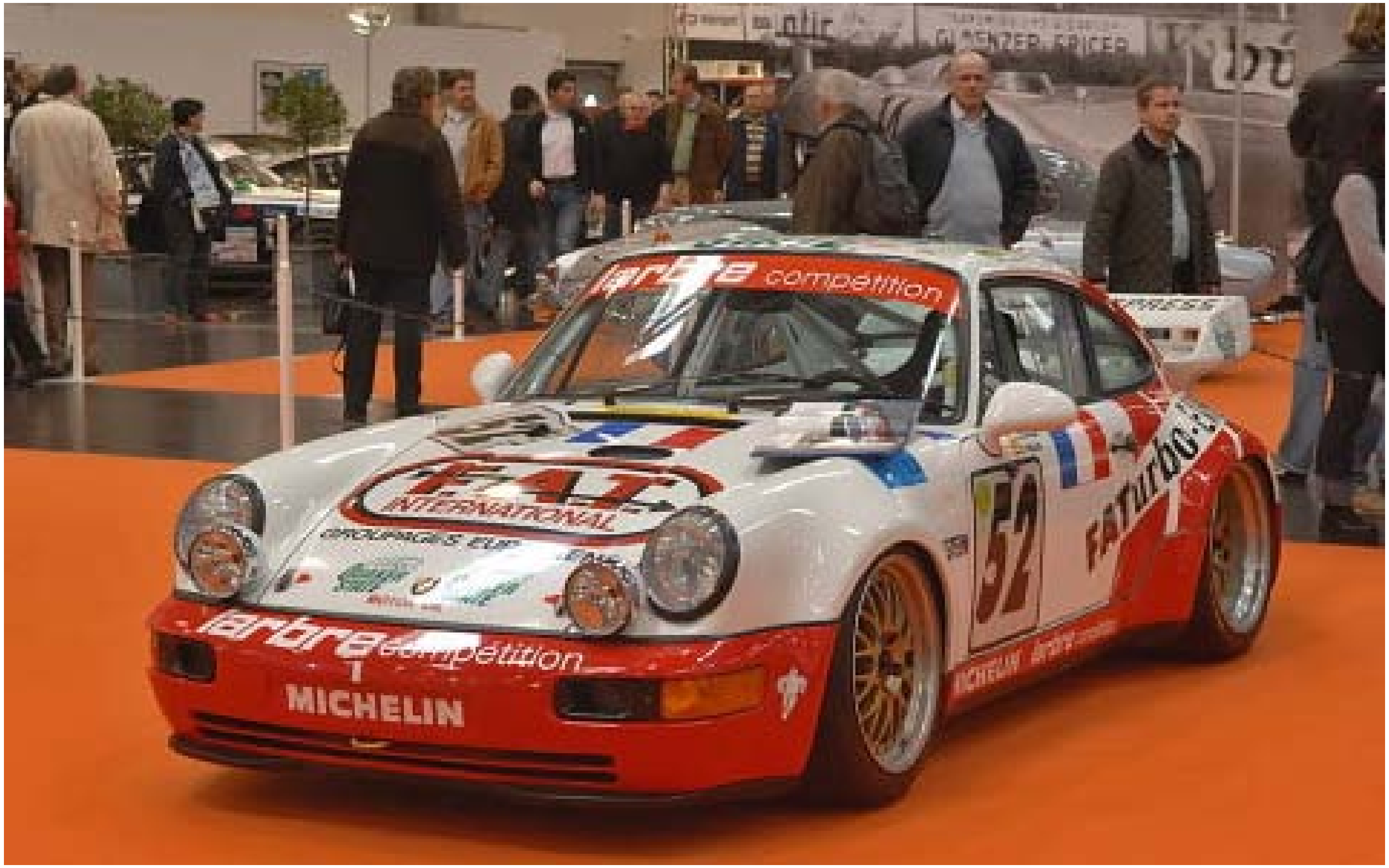
Similarities

- Vesting
- Deadlines
- "Held for" requirement
- Identification requirements
- "(g)(6)" Regulations

Differences

- "Like Kind" standard
    - General Asset Class / Product Class
- Depreciation recapture significance

COLLECTIBLE EXCHANGE - PORSCHE



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WHAT'S "LIKE KIND"

1. Same General Asset Class (Rev Proc 87-56)
2. Same NAICS 6 Digit Product Class
   - Property classified within any General Asset Class may not be classified within a Product Class
3. "Like Kind" (Nature & Character)

Personal Computer	⟷	Printer (Same Gen Asset Class)
Sanding Machine	⟷	Lathe (Same 6 digit NAICS)
Automobile	⟷	SUV (Like Kind)
Franchise Rts. – Wendy's	⟷	Franchise Rts. – Burger King
Copyright -Novel	~~⟷~~	Copyright -Song
Goodwill -Bookstore	~~⟷~~	Goodwill -Food Mart

PROGRAM (MASTER) EXCHANGES

- Basic §1031 rules still apply
- One Master Agreement that covers a series of accounts and exchanges of one or more classes (types) of assets
- Assignments and notifications are generally automated or included in sale documents
- As much a banking solution as tax deferral
- Very beneficial to any flow business such as leasing or equipment rental companies

PROGRAM (MASTER) EXCHANGES *(CONT.)*

- **Who Benefits**
  - Taxpayers that routinely divest & replace tangible depreciable assets
  - Assets have residual value greater than tax basis – accelerated depreciation
  - Taxpayers not in AMT or NOL situations

- **Typical Target Companies**
  - Auto/Truck/Equipment Leasing Companies
  - Railroads / Railcar
  - Construction/ Agricultural / Mining Equipment

ARTWORK EXCHANGES

ART INVESTOR v. COLLECTOR

1. Art Investor: Someone who buys and sells artwork primarily for investment
2. Art Collector: Someone who buys and sells artwork primarily for personal pleasure, use and enjoyment

- How do you determine a taxpayers intent?
  - Treas. Reg. §1.183-2
  - Intent determined based on taxpayer's tax filings and activities

- There is little published guidance
  - The standard is interpreted conservatively

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ESTABLISHING QUALIFIED INVESTMENT INTENT

- Maintain complete records of purchase, maintenance expenses, etc. related to the asset being disposed and the one acquired
- Seek the advice of expert consultants regarding assets being disposed of and acquired
- Have assets reappraised from time to time
- Obtain appropriate title insurance and property/ casualty insurance
- With respect to the asset, behave in a manner that is consistent with an expectation of a profit as one of the main motivations to acquire and hold the asset

SECTION 121 AND SECTION 1031

- Taxpayer is entitled to exclusion from gain recognition on sale of **primary residence** up to:
  - **$250,000** single taxpayers or **$500,000** for married taxpayers filing jointly

- **IF** it has been used as the primary residence for 2 of the 5 years preceding the sale.

- **<u>Additional Rules</u>**
  - Two years do not have to be continuous
  - Property does not have to be primary residence of taxpayer at the time of the sale BUT can have only one primary residence at a time
  - The exclusion can only be used once every two years

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COMBINING SECTION 121 AND SECTION 1031

- Can a taxpayer ever change his intention as to an asset?

- Can taxpayer "convert" an investment property to a primary residence to gain the benefits of Section 121?

- Can taxpayer convert a primary residence to an investment property?

The Jobs Creation Act of 2004

- Restricts benefits of §121 when taxpayer's primary residence was a property "converted" from an investment property.

- Now, for those properties to be eligible for Section 121 treatment, it requires that the taxpayer hold the property for an ***aggregate five year period***, including two years of primary residential use before utilizing the exclusion under §121.

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HOUSING ASSISTANCE TAX ACT OF 2008

- Amends §121 to further restrict its exclusion benefits
- $250,000 / $500,000 exclusion no longer applies to periods of “Non-qualified” use
- Non-qualified: “Any use other than primary residential” by the taxpayer. Thus, no exclusion allowed for portion of ownership that was either:
  - Rental (Investment) or Personal use (Second or Vacation Home)
- §121 Exclusion is now allocated based on ratio of qualified use period to ownership period
- Nonqualified use prior to January 1, 2009 is not taken into account for the nonqualified use period (but is considered for the ownership period)

SECTION 121 EXAMPLE

- TP is single
- 2007 - TP purchased condo as Replacement Property for $300,000 and rented it out
- 2011 - TP moves into the condo as his personal residence
- 2013 - TP sells unit for $600,000.

EXAMPLE AFTER AMENDMENT

Pre Amendment Calculation

Basis (Orig. Purchase Price)	$300,000.00
Depreciation Adjustment	(Ignored for this example)
Adjusted Basis	$300,000.00
Sales Price	$600,000.00
Adjusted Basis	$300,000.00
Realized Gain	$300,000.00
Gain Excluded under §121	$250,000.00
Taxable Gain	$ 50,000.00

Post – Amendment Calculation

Basis (Orig. Purchase Price)	$300,000.00
Depreciation Adjustment	(Ignored for this example)
Adjusted Basis	$300,000.00
Sales Price	$600,000.00
Adjusted Basis	$300,000.00
Realized Gain	$300,000.00
Gain Excluded under §121*	$100,000.00
Taxable Gain	$200,000.00

- ** 2 years non-qualified use / 6 years of ownership*
- *2/6 x $300,000 = $100,000*

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VACATION HOMES AND SECOND HOMES

1. Taxpayer must own property for 24 months prior to the exchange, and

2. Taxpayer must rent for 14 days or more in each of the two 12-month periods immediately preceding the exchange.

3. Taxpayer's personal use in each of those years must not exceed the greater of 14 days or 10 percent of the number of days the property was rented at fair rental rates.

4. Replacement Property must meet the same criteria as outlined above.

INSTALLMENT SALE CONTRACT

1. How can a taxpayer selling via an Installment Sale contract implement a §1031 exchange?
   - The taxpayer should initiate the exchange before the property has been transferred to the purchaser or the initial payment has been received
   - The initial payment and note should be made payable to the Qualified Intermediary
   - When the taxpayer is ready to purchase the new property to complete the exchange, the taxpayer must buy the note from the §1031 Intermediary
2. Will property acquired on an Installment Sale qualify under §1031?
   - Yes, even though the deed does not pass to the taxpayer at the initial closing, the benefits and burdens of the property do transfer to the taxpayer at closing

PARTNERSHIPS AND §1031 EXCHANGES

CODE SECTION 1031 SPECIFICALLY STATES THAT AN INTEREST IN A PARTNERSHIP DOES NOT QUALIFY AS LIKE KIND PROPERTY. THEREFORE, IT IS NOT POSSIBLE TO EXCHANGE A PARTNERSHIP INTEREST EVEN IF THE PARTNERSHIP OWNS PROPERTY

PARTNERSHIP ISSUES

COMMON SCENARIOS:

1. A partnership owns property and wishes to sell it. Some of the partners want to engage in a §1031 tax deferred exchange upon the sale and some do not.
2. A partnership owns property and wishes to sell it. All of the partners would like to participate in a §1031 tax deferred exchange, but the partners do not want to purchase the new property together

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POSSIBLE SOLUTIONS

IF MOST OF THE PARTNERS IN THE PARTNERSHIP WISH TO COMPLETE THE §1031 EXCHANGE TOGETHER:

1. The partnership could sell the relinquished property, distribute a portion of the proceeds to the partners who wish to cash out and use the remaining proceeds to purchase the new property.
   - **ISSUE:** The partners that are cashing out would receive a special allocation of the gain from the sale of the property. This gain maybe greater for the partners that cashed out.

2. The partnership could buy out the partners that do not wish to participate in the §1031 exchange.

Exchanger should consult his tax advisor to navigate the partnership issues

WHAT IF THE PARTNERS DO NOT WISH TO PURCHASE THE NEW PROPERTY TOGETHER?

THE PARTNERSHIP CAN BE LIQUIDATED AND TERMINATED AND THE RELINQUISHED PROPERTY DISTRIBUTED TO THE PARTNERS AS TENANTS IN COMMON.

- This should be done as far in advance of the sale as possible.
- If a distribution or dissolution occurs shortly prior to the sale, the key issue is whether the relinquished property was "held for productive use in a trade or business or for investment purposes."

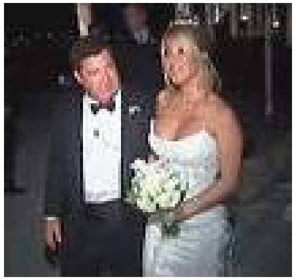
SECURITY OF §1031 FUNDS

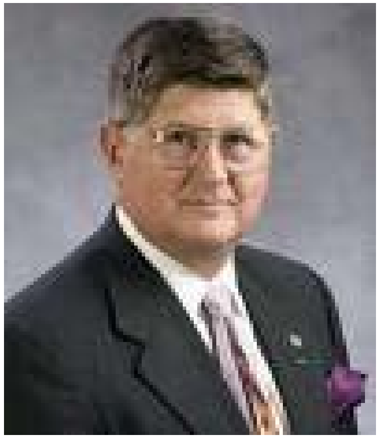
IN 2009 $1 BILLION OF TAXPAYERS §1031 FUNDS WERE LOST

HOW DID THIS HAPPEN?

1. Qualified Intermediaries are not regulated or monitored by the Federal Government, but a few states have recently enacted legislation.
2. Treasury Reg §1.1031(k)-1(f) Taxpayers must not have actual or constructive receipt of the sale proceeds from their relinquished property until the replacement property has been purchased and the exchange has terminated.

SCARY STORIES





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HOW CAN YOU PROTECT YOUR CLIENTS?

- IN THE CURRENT STATE OF THE ECONOMY, IT IS NECESSARY TO DO MORE DUE DILIGENCE
- REVIEW §1031 DOCUMENTATION
- INQUIRE ABOUT THE ACCOUNT STRUCTURE THE QUALIFIED INTERMEDIARY IS USING
- WORK WITH A PUBLICLY-TRADED QUALIFIED INTERMEDIARY

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WHAT ARE THE RISKS IN DOING §1031 EXCHANGES?

- QI Bankruptcy
- Bank Failure
- Investment Failure
- Incompetence of QI

BANKRUPTCY RISK

- How Financially Stable is QI?
- Who owns the QI? How financially stable are its owners?
- What is the account structure?
- What does the Exchange Agreement say about account titling and control?

BANK FAILURE

- What criteria does QI use to pick its bank or will it use any bank?

- Look for additional deposit insurance (up to $10mm) sold by Hartford Insurance

QUALIFIED TRUST/ QUALIFIED ESCROW

- A QE or QT can help taxpayers mitigate the risk of bankruptcy and bank failure.
- If comfortable with documents & QI, then QE or QT is not necessary.
- If using QE or QT:
  - Where is the money?
  - How is it invested? If held in pooled investment, QE / QT **WON'T** protect against investment failure!
  - Expect more cost, more paper, more time
- What if a QE/QT was implemented and the Qualified Intermediary goes bankrupt in the middle of the exchange?
  - Client funds would be safe

INVESTMENT FAILURE

- In the current state of the economy, we do not recommend that exchange funds be invested
- If the QI does invest funds, they should adhere to the Prudent Investor Standard with investment goals of liquidity & preservation of principal
  - FEA Code of Ethics
  - Several State Laws
- Segregated investments for segregated accounts

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RISK OF AN INCOMPETENT QI

- *Bottom Line* - Don't forget the importance of a competent Qualified Intermediary
- Utilize a Qualified Intermediary that has counsel on staff to help ensure that the Intermediary is current with the latest regulations regarding documentation and account set-up
- Protecting §1031 Exchange taxpayers is a Balancing Act

SECURITY FEATURES YOU SHOULD LOOK FOR IN A QI

- Performance Guaranty issued on each exchange
- Fidelity Bond
- Errors and Omissions Insurance
- Transparency about entire organization
- Exchange funds deposited into segregated, interest bearing bank accounts that are separately identified to each Exchanger.
- Disbursement of exchange funds requiring written authorization of the Exchanger
- Exchange funds deposited into highly rated financial institutions.

FOR MORE INFORMATION

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Thank you for attending today's seminar

- Presentation is available to download on the Schneider Downs website:
  - http://www.schneiderdowns.com/1031Presentation

- Please return your survey to the registration desk.

- For more information about Schneider Downs, please contact:

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