Calculating Taxes:
Understanding Adjusted Basis and Gain

Many property owners are familiar with the "Terrible T's" in real estate: termites, tenants and trash. Often the "Terrible T's" become so burdensome that investors decide they want out of real estate altogether. At that point however, investors become all too familiar with another "Terrible T" – Taxes!

Almost all states require the payment of capital gain taxes, so when selling investment real estate, taxes will likely be paid at both the federal and state level. For purposes of this example, we will assume a property was sold in California in 2015. In the state of California, the sale of investment real estate will result in the following tax liabilities:

- 9.3% state capital gains tax rate
- 15% federal capital gains tax rate
- 25% depreciation recapture tax rate

Calculating the tax bill upon the sale of a property isn't as hard as one might think, but it does require that you have a firm understanding of how much gain is in the property.

Types of Exchanges

SIMULTANEOUS EXCHANGE In a simultaneous exchange, the relinquished property is sold and the replacement property is acquired on the same day, with concurrent closings. The simultaneous exchange is rare and investors should still use an Exchange Accommodator when doing a simultaneous exchange.

DELAYED EXCHANGE The most common method of exchanging, the delayed exchange, allows investors to sell a property and then acquire replacement property within 180 days.

REVERSE EXCHANGE The reverse exchange allows investors to acquire replacement property prior to selling. The reverse exchange can be more complicated however, as investors cannot own both the new replacement property and (soon to be) relinquished property at the same time. Asset Exchange Company, as an Exchange Accommodating Titleholder, will need to go on title to one of the two properties involved in the exchange. Investors considering a reverse exchange should contact Asset Exchange Company well in advance of closing on the replacement property. For more information about the reverse exchange, please call 877.471.1031 for a free consultation.

CONSTRUCTION/ IMPROVEMENT EXCHANGE The construction exchange allows investors to use exchange proceeds to build on land or improve an existing property. The construction/improvement exchange is often used to acquire a 'fixer' and do improvements on the existing structure. Not all clients qualify for a construction exchange, so please call Asset Exchange Company to discuss the process.

The Exchange Process – Four Simple Guidelines

Strict adherence to the legal requirements of Section 1031 of the Internal Revenue Code is required for a successful exchange. Investors should be aware of four basic requirements when entering into a delayed exchange and should seek the advice of a tax accountant or attorney to ensure proper adherence to the tax code. The four basic requirements for a successful exchange are:

PROPERTY QUALIFICATIONS **1** The Internal Revenue Code states that the properties involved in an exchange must be held for productive use in trade or business or for investment and they must be "like-kind."

TIMELINE **2** The IRS provides a maximum of 180 days to complete an exchange. The timeline begins upon the close of escrow (COE) of the relinquished property. The new property (or properties) must be acquired on or before midnight of the 180th day. No Exceptions! In addition, the IRS requires that all potential replacement properties be identified by midnight of the 45th day of the exchange.

IDENTIFICATION 3 Identification of all potential replacement properties is required on, or before, day 45 of the exchange. Identification must be in writing and the description of the properties must be unambiguous. The IRS provides two rules for identifying replacement property:

- *The 3 Property Rule*

  The 3 Property Rule allows for identification of any three properties, of any price, anywhere in the United States.

- *The 200% Rule*

  The 200% Rule is an option for identifying more than three properties. With the 200% Rule, four or more properties can be identified. However, the combined value of all properties identified cannot exceed 200% of the property sold.

TAX DEFERRAL 4 To defer 100% of the capital gains tax liability, two requirements must be met:

- *Reinvest all the Cash*

  All the cash that was generated from the sale of the relinquished property must be reinvested into the new property or properties.

- *Purchase Equal or Greater in Value*

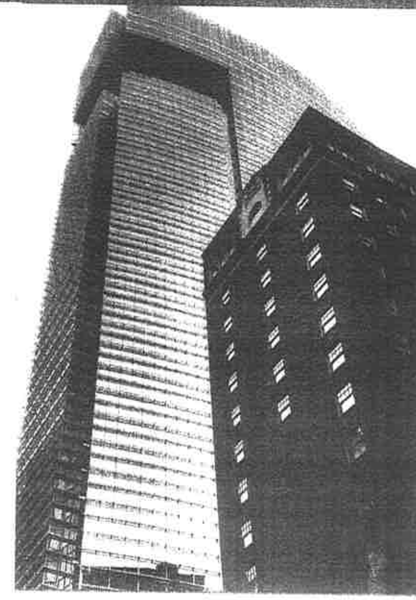
  The new property, or properties, must be equal or greater in value to the property sold.

Frequently Asked Questions

Q: ***How long do I have to own a property before I can exchange it?***
A: The longer the better. Unfortunately, there is no safe holding period for property to automatically qualify for an exchange. Keep in mind, the property only needs to be "held for investment" for it to be eligible for an exchange. Time of ownership is only one factor the IRS looks at when determining if the property was "held for investment". Some tax advisors recommend a minimum holding period of one year.

Q: ***Can I sell my duplex and purchase raw land?***
A: Certainly. Properties involved in an exchange need to be held for either productive use in trade or business or for investment. Holding land for future appreciation is considered held for investment. Do not get confused by the "like kind" requirement. "Like kind" can be any real property used for business or investment purposes within the U.S.

Q: ***Can I buy my replacement property first?***
A: Yes. This requires a reverse exchange. A reverse exchange may be an option provided it is structured according to the safe harbor guidelines.



Q: ***Can I move into a rental property that was originally purchased as part of a 1031 Exchange?***

A: Yes. However, please keep in mind that the IRS will look at your "intent" in determining if your exchange is valid. If the IRS feels your original intent when the property was initially acquired was to use it as a primary residence, you may have your exchange disqualified. We recommend renting a property out for at least 2 years before using it for personal use.

Q: ***Do I have to reinvest ALL of my cash (equity)?***

A: No. However, any cash (equity) that is not reinvested in real estate will be taxable (and is known as cash boot). The general rule of thumb, if you don't want to pay any taxes, is to reinvest all of your cash and purchase a property equal or greater in value.

Q: ***How long do I have to complete my exchange?***

A: 180 days. However, also keep in mind you will be required to identify your potential replacement properties on day 45 of your exchange. Your timeline starts when you close escrow on the property you are selling.

Q: ***How do I get my exchange started?***

A: Call Asset Exchange Company once you've opened escrow. We'll draft up an exchange agreement and coordinate with you and your escrow company to facilitate the exchange.

The first thing to understand is how to calculate the Adjusted Basis:

Formula	Example
Net Purchase Price	$500,000
(Depreciation)	(100,000)
+Capital Improvements	+25,000
Adjusted Basis	$425,000

Once the Adjusted Basis is figured, calculating the Gain is easy:

Formula	Example
Net Sales Price	$1,000,000
(Adjusted Basis)	($425,000)
Gain	$575,000

With the gain calculated, tax computations are relatively simple:

Tax Rates	Formula	Tax Amount
9.3% State Tax	9.3% * Gain	$53,475
15% Capital Gain	15% * (Gain – Depreciation)	$71,250
25% Depreciation Recapture Tax	25% * Depreciation	$25,000
Total Tax		$149,725

Please note: This example is for demonstration purposes only. Additional taxes may apply. Federal Capital Gains taxes may be 20% depending on income and an additional 3.8% Medicare tax may be owed. California taxes may also be higher depending on total income.

Reverse 1031 Exchange

In a typical 1031 Exchange, relinquished property is sold and then replacement property is purchased. On occasion, it may be advantageous to do the reverse; purchase replacement property first and then sell relinquished property. Such a process is aptly named "Reverse Exchange" and is an accepted method of exchanging under current tax law (Revenue Procedure 2000-37).

Issues: A reverse exchange presents three notable challenges. First, the relinquished and replacement properties cannot be owned by the investor at the same time. Therefore, an Exchange Accommodating Titleholder (EAT) will take title to the replacement property. The qualified intermediary working on the exchange will generally set up the EAT. After the EAT takes title to the replacement property, the investor will have the normal 180 days to complete the exchange by selling the relinquished property

The second challenge is financing the replacement property. Funds need to be available for the purchase of the replacement property prior to the sale of the relinquished property. An investor contemplating a reverse exchange will need to have cash available to spend out of pocket. Since the EAT will acquire title to the replacement property, a lender will generally not lend money to the EAT. Almost always, a reverse exchange requires the investor to purchase the replacement property all cash.

Third and finally, a reverse exchange will add several thousand dollars in additional exchange fees and closing costs to the exchange transaction which makes it the most expensive method of exchanging.

Alternative Structures: The preferred method of completing a reverse exchange is for the EAT to take title to the replacement property in an all cash purchase. However, it is sometimes possible for the EAT to take title to the relinquished property. It is also possible for the EAT to take title to the replacement property and for a loan to be part of the purchase price. Such alternative structures are rare and often difficult to accomplish.

Advanced Issues:

- The funds used to acquire the replacement property must be advanced by the investor as a loan to the EAT. The EAT will pay back the loan after the relinquished property is sold.
- The investor will have full access to the replacement property during the EAT ownership and can rent the property immediately.
- In order for the EAT to take title and then transfer ownership to the investor, a single member LLC will usually be used. At the completion of the exchange, the EAT will generally transfer the LLC to the investor rather than recording a deed. Transferring the LLC to complete the exchange will likely save on transfer taxes but will require the investor to manage the LLC after the completion of the exchange.
- Reverse exchange also requires specific and unique tax reporting at year end and the Qualified Intermediary will assist with such reporting.