

1031 EXCHANGE INSIGHTS

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Providing tax advice on like kind exchanges.

Strategic Property Exchanges, LLC serves as Qualified Intermediary on

Section 1031 Exchanges, including forward, reverse, and parking arrangements.

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INVESTMENT STRATEGIES- PART II

Section 1031 can help real investors in a number of ways, including, preservation of capital gains to acquire more desirable properties and increase your rate of return by reducing the amount of taxes you pay on your real estate investments. One of the more common questions I am asked each week involves seller financing, installment sales and leases with options to buy.

As a Purchaser, a Lease with Option to Buy permits an investor to carefully time the acquisition date of the replacement property as long as the transaction is not treated as a disguised purchase. Do not treat any of the lease payments as credited to the purchase price.

As a Seller of the property, a real estate owner can also time the sale of the property, enabling the Seller to find suitable replacement property while ensuring a sale of the property within a certain time frame.

Under federal tax law, the option is not income until the date of the sale. However, recently some governments have recently implemented regulations on residential lease-option transactions to limit this type of

activity. For example, the City of Cincinnati limits the option fee to 4 times the monthly rent, spread over 3 years.

If the lease with an option to purchase is treated as a sale, wherein additional payments are credited against the purchase price, this may be treated as a sale under many standard mortgages, such as Fannie Mae and Freddie Mac loans triggering the due on sale clause.

Seller Financing: An investor may sell his or her property, take back a seller mortgage for a portion of the purchase price and treat the sale of the property as a Section 1031 exchange. However, there is one very large caveat. The amount of the seller mortgage must be contributed by the Seller's own personal funds in order to purchase the replacement property. This may mean selling invested assets such as stocks and bonds or borrowing against other real estate in order to avoid taxation of the sale of the property. For example, if Mr. S [eller] sells his apartment building for \$800,000 to Mr. B [uyer] and takes back a \$160,000 note, [20%]. Mr. S will need to contribute 160,000 of his own cash to purchase the replacement property within 180

days. This deficiency cannot be borrowed on the property to be purchased, though it can be borrowed on other unrelated real estate owned by Mr. S. Further, if Mr. B defaults on the payment of the mortgage, this cannot be taken as a capital loss since the transaction in which it arose was a non taxable transaction.

Installment Sales are another version of Seller financing, where the Seller agrees to take one or more payments over a period of time over at least two tax years. The full amount of the Sale Price must be reinvested within the 180 days to avoid immediate taxation. Further, depending on how the transaction was structured, the future payments may also be taxed on receipt, reducing the value of the Section 1031 exchange.

Let us at Strategic Property Exchanges, LLC assist you in your next 1031 exchange. Our tax opinions will provide to you the confidence and assurance that your exchange will not be challenged by the IRS and you are protected against tax penalties. Steve Robison, Esq. is a Board Certified Tax Attorney and has been serving tax and real estate clients for 20 years.

Coming Next Month

Is a 1031 Exchange right for you?