

WHAT THIS COURSE IS ABOUT

It's not what you earn.

It's what you keep.



WHAT THIS COURSE WILL COVER

- How to calculate basis, depreciation and taxable gain
- IRC §1031 Tax Deferred Exchange
- IRC §1033 Condemnation Exchange
- Installment sales IRC §453
- Replacement Property Strategies





COST BASIS, DEPRECIATION, CAPITAL IMPROVEMENTS AND DEPRECAITION

- In order to figure out a capital gain you must first determine the adjusted basis in a property.
- Many people talk about "basis" but "adjusted basis" is the figure that is important to figure out a gain.
- Cost Basis is generally what an investor pays for a property, plus closing costs. If the property is
 acquired in an exchange or non-arms length transaction the basis may be different.
- Closing costs do not include prorated items (e.g., taxes, insurance, rent); finance charges paid by the buyer; or expenses that physically affect the property (e.g., repairs)
- Adjusted Basis is the cost basis of the property, plus capital improvements, minus depreciation.
- Capital Improvement If the improvement materially adds to the property's value (not just a repair) and prolongs the property's useful life.



WHAT IS DEPRECIATION?

- Depreciation is the periodic expending of an asset over the property's theoretical economic life.
 IRC §1250
- This tax deduction is intended to recognize the decrease in value caused by, among other things, wear and tear, and outdated interior improvements.
- Investors benefit from depreciation deductions while they own property, but it is a liability when property is sold.
- An investor's cost basis is reduced by the amount of depreciation they have taken.
- Land is generally not depreciable and an investor must allocate the purchase price between the land and improvements. (Properties rarely have a true zero basis.)



WHAT IS DEPRECIATION RECAPTURE?

- Depreciation not only causes a reduction in basis, but is taxed at the Federal level at 25%, instead
 of 23.8% capital gain tax rate.
- Most states do not have a separate rate specific to depreciation recapture. Instead, depreciation
 is taxed at a capital gain tax rate.
- For Federal tax purposes the adjusted basis must be divided into gain from appreciation and depreciation.
- Property that has not appreciated can still have a gain due to depreciation recapture.



SAMPLE DEPRECIATION SCHEDULE

Period	Year	Book Value Period Start	Depreciation Expense	Accumulated Depreciation	Book Value Period End
1	2000	\$1,000,000	\$24,573	\$24,573	\$975,427
2	2001	\$975,427	\$25,641	\$50,214	\$949,786
3	2002	\$949,786	\$25,641	\$75,855	\$924,145
4	2003	\$924,145	\$25,641	\$101,496	\$898,504
5	2004	\$898,504	\$25,641	\$127,137	\$872,863
6-35	2005- 2034	\$872,863- \$129,274	\$25,641	\$152,778- \$896,368	\$847,222- \$103,632
36	2035	\$103,632	\$25,641	\$922,009	\$77,991
37	2036	\$77,991	\$25,641	\$947,650	\$52,350
38	2037	\$52,350	\$25,641	\$973,291	\$26,709
39	2038	\$26,709	\$25,641	\$998,932	\$1,068
40	2039	\$1,068	\$25,641	\$1,000,000	\$0



FIGURING OUT A CAPITAL GAIN

1st Calculation: Net Adjusted Basis	
Original Purchase Price (Basis) Add: Capital Improvements Less: Depreciation	\$400,000 + \$50,000 - \$275,000
Equals: Net Adjusted Basis	\$175,000
2nd Calculation: Capital Gain	
Today's Sales Price Less: Net Adjusted Basis Less: Cost of Sales	\$2,000,000 - \$175,000 - \$175,000
Equals: Capital Gain	\$1,650,000
3rd Calculation: Tax Due	
Recaptured Depreciation Straight-line (\$275,000 x 25%) Federal Capital Gain (\$1,375,000 x 23.8%) Kentucky Tax (\$1,650,000 x 5%)	\$68,750 \$327,250 \$66,000
Total Tax Due	\$ 462,000



COMMON MISCONCEPTIONS REGARDING GAIN

- Gain is the amount of equity left in the property.
- If a property is foreclosed there is no gain.
- If an investor buys a property for \$3M, and it rises to \$5M, before retreating to \$4M, at which point it is sold, the investor has a \$1M loss.
- If an investor did not take depreciation that they were entitled to they do not have to worry about depreciation recapture when they sell.





OVERVIEW AND MYTHS OF IRC §1031 TAX DEFERRED EXCHANGES



- An exchange is no longer an actual "swap".
- It is sale and purchase with very little difference than a non-1031 transaction.
- Exchange documents create the transaction.
 - The gain from the relinquished property is deferred into the replacement property.



IRC §1031 TAX DEFERRED EXCHANGES

No gain or loss shall be recognized on the exchange of real property held for productive use in a trade or business or for investment if such real property is exchanged solely for property of like-kind which is to be held either for productive use in a trade or business or for investment.

Deferral of tax, <u>NOT</u> a tax-free transaction.



Rules for a 1031 Exchange

Receive nothing but Like-Kind property

Like-Kind – Any Real Property interest held for productive use in a trade or business or for investment purposes.





LIKE KIND - REAL PROPERTY

INTENT

Intent: actions over a period of time.

LIKE KIND

Held for productive use in a trade or business.

or

Held for investment purposes.



Rules for a 1031 Exchange

Receive nothing but Like-Kind property

Not Like-Kind

HELD FOR RESALE

VACANT RETAIL NEW



TENANTED RETAIL



HELD FOR PERSONAL USE

SINGLE FAMILY



SINGLE FAMILY FOR RENT







RULES TO OBTAIN A COMPLETE DEFERAL

- Purchase replacement property of equal or greater value to the relinquished property.
- Reinvest all of the net proceeds from the relinquished sale into the replacement property purchase.
- Obtain equal or greater financing on the replacement property as was paid off on the relinquished property.
- Receive nothing except like-kind property (productive use in a trade or business; or held for investment purposes).

DELAYED EXCHANGE STRUCTURE





IDENTIFICATION RULES

THREE PROPERTY RULE

Exchanger may identify up to three properties regardless of value.

200% RULE

• Exchanger can identify an unlimited number of properties, provided that the total value of the properties identified does not exceed 200% of the value of all relinquished properties.

95% EXCEPTION

 If Exchanger identifies more than three properties which are worth more than 200% of the value of all relinquished properties than Exchanger must acquire 95% of the value of all properties identified.



PROCEDURE FOR PROPER IDENTIFICATION

- Identification must be made in writing.
- Unambiguously describe the property.
- Signed and dated by the taxpayer.
- Received by midnight of the 45th day or postmarked by the 45th day.
- Delivered to Exchanger's Qualified Intermediary or to a party related to the exchange who is not a disqualified person.



EXCHANGE VESTING ISSUES

- With very limited exception, the person or entity who relinquishes property must be the same person or entity to buy the replacement property.
- A good rule of thumb is that you must have the same tax identification number on both sides of the transaction.





IRC § 1033 CONDEMNATION EXCHANGE

- IRC § 1033 operates very similar to IRC § 1031 in that it defers a capital gain tax upon the involuntary conversion of a property.
- An involuntary conversion occurs when an investor's property is destroyed by casualty or taken in condemnation and the owner uses the insurance or condemnation proceeds to acquire replacement property.
- The IRS requires that the involuntary conversion must be by reason of destruction, theft, seizure, requisition, or condemnation.
- A threat or imminence of condemnation can justify a voluntary conveyance of property to the condemning authority.



IRC § 1033 CONDEMNATION EXCHANGE

- The cost of the replacement property must be equal or greater than the net proceeds received (including payoff of any mortgages) from the converted property.
- Taxpayer does not have to use the actual funds received from the condemnation award to acquire the replacement property. Unlike a § 1031 exchange the taxpayer may obtain a larger mortgage on the replacement property.
- Property acquired must be similar or related in service or use; or
- If the subject property being condemned was held for productive use in a trade or business the "like kind" requirements of IRC § 1031 can be used.



IRC § 1033 CONDEMNATION EXCHANGE

- The replacement property must be acquired within two years after the close of the first tax year in which any part of the gain is realized, unless the property was held for productive use in a trade or business or for investment purposes, in which case the investor has three years to acquire replacement property.
- IRS has ruled that under certain circumstances the acquisition of an entity which owns qualifying replacement property will be deemed a valid 1033 replacement property. (Similar use rule must be used – not like kind.)





INSTALLMENT NOTE TREATMENT

- IRC § 453 provides that to the extent a taxpayer does not receive consideration from a sale they are not taxed on the amount outstanding.
- An installment sale occurs when the taxpayer receives at least one payment after the close of the taxable year in which the sale or exchange occurs. IRC § 453(b)(1)
- Installment sales may not be used to defer the recognition of a loss. A loss must be reported in the year of the sale. Rev. Rul. 70-430.
- Installment sale treatment may not be used by dealers of real or personal property.
 IRC § 453(b)(2)



INSTALLMENT NOTE TREATMENT

- In order to figure out what portion of an installment note payment is taxable the taxpayer must determine the gross profit percentage.
- GROSS PROFIT PERCENTAGE the ratio of the gross profit realized to the contract price. IRC § 453(c)
- If part of the gain recognized is from unrecaptured IRC § 1250 depreciation the taxable portion of the gain received is paid first at the higher depreciation recapture rate. (For sales after August 23, 1999) Reg. § 1.453-12
- Certain depreciation methods can cause the recapture to be reclassified as ordinary income and not treated as an installment sale. (e.g. – ACRS commercial real property depreciated using accelerated depreciation instead of straight line.)
- If a buyer assumes a mortgage liability in excess of the basis of the sale property the difference is considered a payment in the first year. IRC § 453(f)(3)



DETERMINING GROSS PROFIT PERCENTAGE

1st Calculation: Realized Gain	
Sale Price Less: Adjusted Basis Less: Selling Expenses	\$800,000 - 100,000 - 40,000
Equals: Gross Profit to be realize	\$660,000
2nd Calculation: Contract Price	
Selling Price Less: Assumed Mortgage	\$800,000 - 0
Equals: Contract Price	\$800,000
3rd Calculation: Gross Profit Percentage	
Realized Gain (1 st Calculation) Divided By: Contract Price (2 nd Calculation)	\$660,000 \$800,000
Gross Profit Percentage	0.825 or 82½%



DETERMINING GAIN USING GROSS PROFIT PERCENTAGE

ASSUMPTIONS

Sales Price: \$800,000, 1st Year Down Payment: \$200,000, \$60,000 per year for 10 years.

Basis \$150,000 - \$50,000 depreciation = \$100,000 Adjusted Basis.

1st Calculation: First Year Down Payment	
Down Payment Multiply: Gross Profit Percentage	\$200,000 x 82.5%
Taxable Gain Multiply: \$50,000 x 25% Depreciation Recapture Multiply: \$115,000 x 23.8% Capital Gain Tax	\$165,000 \$12,500 \$27,370
Equals: Tax Due on First Year Down Payment	\$39,870
2nd Calculation: Subsequent Year Payments	
Installment Payment Multiply: Gross Profit Percentage <u>Taxable Gain</u> Multiply: \$49,500 x 23.8% Capital Gain Tax	\$60,000 x 82.5% <u>\$49,500</u> \$11,781
Equals: Tax Due on Each Installment Payment	\$11,781





MAXIMIZING A 1031 IDENTIFICATION

- Common mistake: Identifying only one property within the 45-day identification period. Risk- If unable to close on the primary property after the expiration of the 45-days the exchange will fail.
- Solution: Utilizing either the 3-property rule or the 200% rule, identify 3 or more properties to provide backup property(s) in case the primary property cannot be purchased
- Additional strategy: Purchasing multiple properties that in the aggregate will complete the equity and financing requirements. One or more properties can be purchased primarily to absorb the residual equity or financing needed to avoid a tax liability. (i.e. - Zero-Coupon)



REPLACEMENT PROPERTY OPTIONS

TRIPLE NET LEASE PROPERTY

- Deeded interest in a property where the tenant is responsible for most or all of the costs (insurance, taxes, maintenance).
- Typically a company develops a location, sells it to an investor, and takes back a long-term lease.
- Examples: CVS, Advance Auto, Home Depot, 7-11.
- Credit of the tenant and time left on a lease can have an effect on the investment's return and subsequent sale price.
- Attractive to investors because they have no day to day responsibility for the property.
- Most net lease properties are priced at \$1M+.



REPLACEMENT PROPERTY OPTIONS

TENANT IN COMMON (TIC) AND DST PROPERTIES

- Undivided fractional co-ownership of real estate between two or more people.
- Separate deeds for each undivided interest.
- Generally, most tenant-in-common ("TIC") and DST programs are treated as real estate for exchange purposes and securities for sales purposes. Buyer must be an accredited investor.
- Flexible investment amounts as low as \$50,000.
- Non-recourse assumable financing available.
- Professional property management provided.
- Certainty of closure once a client has been approved.



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