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Tax Reporting for 1031 Exchanges

The time is at hand to gather the documents, receipts, and forms required to support your tax return preparation for 2009. The tax preparer will want to review the settlement statements from each transaction included in the 1031 exchange, the identification of the replacement property signed by the taxpayer, and the ledger reflecting the deposits and disbursements of exchange funds.

The 1031 exchange is reported in the tax year in which the sale of the relinquished property was completed. For example, if the sale of the relinquished property occurred in 2009, but the purchase of the replacement property was completed in 2010, the exchange would be reported on the 2009 tax return.

IMPORTANT: If the exchange period and/or the purchase of the replacement property have not been completed by the tax filing deadline, the taxpayer must file an extension of time for filing their federal and state income tax returns. Filing your tax return prior to the completion of the exchange may invalidate the exchange and the sale transaction becomes subject to payment of capital gains tax.

Form 8824 - Like Kind Exchange - Required

Part I of Form 8824 asks for the following information.

- 1 & 2 the addresses of the relinquished and replacement properties;
 - 3 the date the taxpayer originally acquired the relinquished property;
 - 4 the date the taxpayer transferred the relinquished property to the buyer;
 - 5 the date the taxpayer identified the replacement property by written notice;
 - 6 the date the taxpayer received the replacement property; and
 - 7 if either the relinquished or replacement properties were transferred between related parties.
- The taxpayer completes Part II of Form 8824 if the answer to Item 7 was yes.

With this information the IRS can quickly assess if the deadlines provided in the regulations for Section 1031 tax deferred exchanges were met.

Part III is completed to calculate (1) the taxpayer's gain on the sale of the relinquished property, and (2) the taxpayer's adjusted cost basis of the replacement property.

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"The tax on capital gains directly affects investment decisions, the mobility and flow of risk capital...the ease or difficulty experienced by new ventures in obtaining capital, and thereby the strength and potential for growth in the economy."

- John F. Kennedy



Failed Exchange – Potential Installment Sale Tax Treatment

The sale of the relinquished property occurred in Year One (i.e. 2009) with a bona fide intent to complete a 1031 tax deferred exchange. If the 45 day identification period or the 180 day exchange period ends in Year Two (i.e. 2010) and the exchange fails, the taxpayer may be able to report the sale as an installment sale under Section 453. Although the depreciation recapture remains applicable to the year in which the sale occurred, the capital gains tax may be deferred until the tax return is filed for the year in which the taxpayer received the exchange funds from the qualified intermediary (Year Two—2010).

Qualifying Under Section 453

The ability to qualify under Section 453 depends on whether the taxpayer had the right to access or had benefit of the funds held by the qualified intermediary. An exchange agreement between the taxpayer and the qualified intermediary should contain the required language from U.S. Treasury regulations for Section 1.1031 prohibiting the taxpayer's rights to the funds until a qualifying event occurs, i.e. the passing of the 45-day identification deadline with no identification delivered, or the passing of the 180-day deadline with no replacement property acquired. This documentation affords the taxpayer the opportunity to put together a financial plan defining which tax year it would be most beneficial to pay the capital gains tax.

Financial Planning / Tax Strategies

Tax Deferral / Tax Exclusion Sections of Federal Tax Code

Section 1031—Exchange of Property Held for Investment

Applies only to properties held for investment or for use in a trade or business.

Applies to real property and personal property.

Requires the services of a Qualified Intermediary.

Section 1032—Exchange of Corporation Stock for Property

Does not apply to real estate. Does not require a Qualified Intermediary.

Section 1033—Involuntary Conversion (Eminent Domain or Natural Disaster)

Two years to replace property destroyed by a natural disaster.

Three years to replace property converted by a condemnation proceeding.

Does not require a Qualified Intermediary.

Section 121—Exclusion of Capital Gain on the Sale of Primary Residence

(Formerly Section 1034)

Does not require a Qualified Intermediary.

Section 1035—Exchange of Life Insurance, Endowment or Annuity Contracts

Applies to the exchange of life insurance, endowment or annuity contracts or policies.

Does not require a Qualified Intermediary.

Charitable Remainder Trusts

Transfer of property or assets to a Charitable Remainder Trust

Benefits charities that taxpayer selects.

Consult with a Financial Advisor / Investment Broker

Taxpayers should review their portfolio with legal, tax and/or financial advisors to achieve the greatest benefit from these deferral / exclusion options allowed through federal tax code.