1031 TaxPak™

GuideBook 2014

for Tax-year 2013

Reporting Your 1031 Exchange

Exclusively for clients of

the 1031 Exchange Experts' LLC

National Qualified Intermediaries

This GuideBook was written by **the 1031 Exchange Experts' llc,** to help clients sort through the complexities of reporting 1031 exchanges. Following this system of examples and WorkSheets should assist even those most unfamiliar with U.S. tax law to properly prepare the tax forms required to report their exchanges.

We, the 1031 Exchange Experts' llc, are a nationwide qualified intermediary specializing in the handling of 1031 exchanges. While this information has been prepared by us to give guidance to our clients in the reporting of their exchanges, no one knows your particular tax situation better than your own tax advisor. Please follow their advice. Do not use this booklet as a substitute for legal or financial advice. This book has been prepared exclusively for the clients of 1031 Exchange Experts' llc and may not be used by others without written permission.

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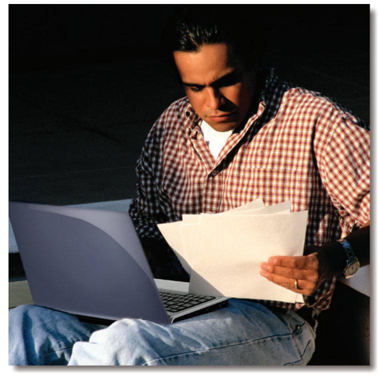


When you chose the 1031 Exchange Experts' llc, we promised

the highest level of service before, during and even after your exchange. Now that you've successfully completed your exchange we're keeping that promise. We proudly present ***1031TaxPak***™, an easy-to-follow guide to help you report your exchange.

Though your exchange is complete, there still remains the final step of reporting your exchange to the IRS. In tax-filing season, you may be wondering what exactly you're supposed to do next. With 1031TaxPak, the *Experts'* are here to guide you through the process.

Reporting your exchange can be confusing, but it doesn't have to be a nightmare. The tax forms you must submit are not very self-explanatory; the IRS typically uses unfamiliar and archaic language, and their instructions can be more confusing than helpful. Finding the numbers you need to fill in the forms can be guesswork if you're not a professional tax accountant.

We created *1031TaxPak* to help you overcome these obstacles. It's designed to do two things for you: 1) explain the tax concepts and terminology in plain, simple English, and 2) provide the resources you'll need to correctly report your exchange. We hope you find *1031TaxPak* helpful, educational and time-saving.

How to use 1031TaxPak

TaxPak is an extension of the 1031 exchange services we provided throughout your exchange. For those of you who prepare your own tax returns, the exchange reporting process may be unfamiliar territory. Aside from Gary Gorman's best-selling 1031 book, *Exchanging Up!*, published guidance on the subject is scarce. By working through our example and WorkSheets, you'll be able to identify and calculate the important figures for your 1031 exchange. With TaxPak as your guide, the IRS forms will make more sense!

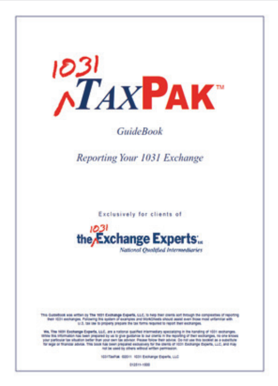
If you hire a professional to prepare your tax returns, you are welcome to give your copy of TaxPak to them. Either way, we should highlight one key point: **As your Qualified Intermediary for this 1031 transaction, *BY LAW we cannot be your personal tax advisor*.** 1031TaxPak assists you with the exchange process, but it is not a substitute for tax or legal advice. Even though we are recognized throughout the world as experts when it comes to 1031 exchanges, we don't pretend to be experts on your personal finances or your tax history to provide such specific advice. **1031TaxPak is NOT a substitute for professional advisors who are trained and licensed to provide you with specialized assistance.** If you need legal or tax advice, or help preparing your taxes, consult your personal tax or legal advisor.

Your PAK-ing List:

In your *1031TaxPak* email, you should find the following items:

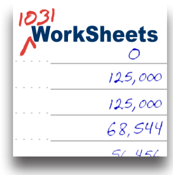
☐ ***Exchange Materials**:* For your convenience, we've provided you with PDF copies of documents you'll need, including:

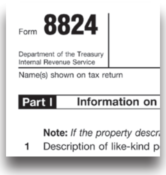
- ☐ **Settlement Statements** from your property sale(s) and purchase(s).
- ☐ A copy of your **Exchange Account Statement**, showing the account history of the exchange funds we held for you.
- ☐ Your **45-Day Identification Form** for identifying your New Property. If you completed your exchange WITHIN 45 days of selling your Old Property, you were not required to submit this form. (If this is you, your TaxPak will not have, nor will you need, a 45-Day Identification Form.)



☐ ***This 1031TaxPak GuideBook:*** The PDF GuideBook you are now reading is like a road map to Form 8824 – and much more. TaxPak clarifies what Form 8824 is asking for, where to find the information, and discusses the concepts and terminology you need to successfully report your exchange. This GuideBook works through a sample exchange, step-by-step, so that you can follow along with your own exchange. It also includes supplementary material for some specialized situations.

☐ ***1031TaxPak WorkSheets:*** We designed a set of WorkSheets to help you with important calculations, such as those illustrated in the GuideBook's sample exchange. The WorkSheets are **NOT** part of Form 8824, so *do NOT submit them with your return.* You can destroy these WorkSheets, or file them with your records.





☐ ***IRS Form 8824***: This is the official 2-page form you submit with your federal tax return to report the details of your 1031 exchange. You may be required to submit additional tax forms and calculations that relate to your exchange, but 8824 is the only form used for reporting the exchange itself.

☐ ***And finally: access to 1031TaxPak.com***. You can always download additional PDF copies from 1031TaxPak.com. The IRS instructions for Form 8824 are also available on the TaxPak web site.

Keeping it Simple...

To avoid over-complicating TaxPak, we've focused it on just the most important and most commonly encountered issues. Throughout the GuideBook you'll find references to supplemental material available at 1031TaxPak.com for specialized situations.

You may also find useful guidance on our website: Expert1031.com is a wealth of general 1031 exchange information, including articles about specific topics relating to 1031 exchanges. You can use our "Ask an Expert" button to submit questions to the *Experts'* online, or you can email questions to taxpak@expert1031.com.

And of course, we're available by phone to answer your questions as they arise. Don't hesitate to contact us nationwide, toll-free, at **866-694-0204** if you have a question that needs an answer right away.

Preparing Form 8824

Let's get started. Your starting point for reporting your 1031 exchange to the IRS is **Form 8824**, titled: *Like-Kind Exchanges*. When referring to real estate, the term ***like-kind*** is very broad, and includes any property held for investment or productive use in a business. For example, a rental house is like-kind to, or 'the same as,' bare land, a warehouse, a restaurant, an office building, etc. You may need to file other forms with your tax return that are related to your investment property, which we will discuss later.

> ***Like-Kind*** *– A broad term for real property that includes any property held for investment, or for productive use in a business.*

You must file Form 8824 with your tax return for the year in which you ***SOLD*** *or transferred property in an exchange, regardless of when you purchased the New Property.* For example, if you sold property on December 20, 2013 as part of a 1031 exchange, and you purchased the New Property on March 12, 2014, you would need to file Form 8824 with your 2013 tax return.

Form 8824 is divided into four parts:

Part I - Information on the Like-Kind Exchange

Part II - Related Party Exchange Information

Part III - Realized Gain or (Loss), Recognized Gain, and Basis of Like-Kind Property Received

Part IV - Deferral of Gain from Section 1043 *Conflict-of-Interest Sales*. Part IV is not relevant to section 1031, so it's not covered in this book.

Completing Part I – Information on the Like-Kind Exchange

Lines 1 and 2. Here you report the address and type of property for both the ***Old Property*** and ***New Property***. If you had more than one exchange during the year, you may report all of them on one form and attach a supporting schedule that contains the information required for each property and exchange. If you choose to do this, write: *see attached schedule* on each line. However, we believe it is easier to prepare a separate Form 8824 for each exchange. You can download more forms at 1031TaxPak.com.

> ***Old Property*** *– Sometimes called the* relinquished property*, or the* 'like-kind property given up.'
>
> ***New Property*** *– also called the* acquisition *or* replacement property*. The tax forms call it* 'the like-kind property received.'

Line 3. Enter the date that you *originally acquired* the Old Property. This is the property you sold in this exchange.

Line 4. Enter the date that you *sold* your Old Property. The date of closing can be found on your HUD, Settlement Statement, or Closing Statement.

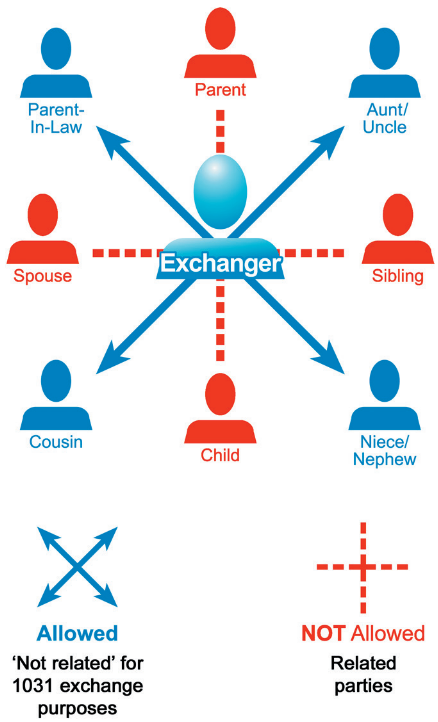
Line 5. Here you enter the date you filed your ***45-Day Identification Form*** with us, the 1031 Exchange Experts' llc, your ***Qualified Intermediary***. This is the form where you listed the properties you were considering for purchase. If you closed on the purchase of your New Property within 45 days of your property sale, you likely did not submit the identification form (and you didn't need to). In that case, enter the *closing date* of the purchase of the New Property on **Line 5.**

> ***45-Day Identification Form*** *– The form provided by your* ***QI*** *that is used to identify your New Property. If completed and returned to us, your 45-Day Identification Form is included in your 1031TaxPak.*
>
> ***Qualified Intermediary (QI)*** *– The 1031 exchange professional that prepared the legal documents and held your proceeds for your exchange. In this case, your Qualified Intermediary is us, the 1031 Exchange Experts' llc.*

Line 6. Enter the date you closed on the purchase of the New Property that you received in your exchange.

Completing Part II – Related Party Exchange Information

Lines 8-11. Part II is completed *only* if you sold property to a relative and/or acquired the New Property from a related party. If there are no related parties involved in the transaction, you can ignore lines 8-11.



For purposes of a 1031 exchange, a ***related party*** would include your spouse, children, grandchildren, brothers, sisters, parents or grandparents. **Related parties also include any corporation, S corp., partnership, LLC, or trust in which you AND/OR *any other related party* own more than a combined 50% interest.** Section 1031(f) of the Internal Revenue Code discusses this in detail.

It is important for you to know that special rules apply if your exchange includes any of these related parties. As part of these special rules, **Lines 8-11** of Form 8824 require you to provide some details about the particular facts of your exchange. Also, if you involve a related party in a 1031 exchange *you must file Form 8824 for the <u>two years</u> following the exchange.* See **Lines 9 and 10** of the form.

Related Party *– If your Old Property buyer or New Property seller is "related" to you, more restrictive rules apply, and you will need to complete lines 8-11 on Form 8824. The IRS does this to make sure the parties involved are not improperly avoiding taxes.*

Other Property *– Any property other than the real estate that is included in an exchange. For example, if you included a car as part of the sale of your Old Property, the car is considered other property. Selling other property in an exchange requires the completion of lines 12-14 on Form 8824.*

Completing Part III – Realized Gain, Recognized Gain *and* Basis *of New Property*

Part III is the most important and most difficult part of Form 8824. It's used to report several pieces of information that are critical to your exchange, including the **realized gain, recognized gain,** (defined on page 8) and **basis** (page 10) of the property received in your exchange.

Aside from the following, it would be nearly impossible to clearly summarize the information you'll compile for Part III. Instead, this GuideBook will instruct you on completing Part III by working through a step-by-step example. Our example uses the WorkSheets to show you how to make the calculations. The example begins on the bottom of page 8.

Lines 12, 13, and 14. Use these lines to report any ordinary gain or loss on ***other property*** (i.e. non like-kind property) included in your exchange. In most cases, other property means property other than real estate. For example, if you sold a rental house in the exchange, and the sale price included the value of a car stored in the garage, you would calculate the gain (or loss) on the sale of the car on these lines. If there was no other property involved in your exchange, skip to **Line 15** and start Part III there.

Lines 15 through 25. Here you will need to compute the realized gain and recognized gain associated with your sale of the property, and the basis of the property you received. ***Realized gain*** is the actual profit, in tax terms, that you made on your property sale. ***Recognized gain*** is the amount of realized gain you'll have to pay taxes on this year. "Basis" refers to the amount of investment in your property for tax purposes, and is discussed in more detail later in this GuideBook. To make the calculations, you can use the WorkSheets provided with your 1031TaxPak. In the following *TaxPak Example* we will work through the WorkSheets with you. *Complete the WorkSheets before you begin Form 8824.*

> ***Realized Gain*** *– The actual increase in the investment value of your Old Property during the time that you owned it.*
>
> ***Recognized Gain*** *– The amount of the realized gain that you are not rolling forward into your New Property. This is the amount that is taxable for the current year.*

Lines 21 and 22. These lines provide instructions on how to calculate ordinary income resulting from depreciation recapture. You do not recapture depreciation from your Old Property if the New Property is also depreciable. If the value of the New Property you acquired exceeds the value of the property you sold, then no depreciation will be recaptured. This concept and the calculations required are discussed later in the GuideBook in the concluding *Buy-Down adjustment* box on page 18, and also in a separate detailed discussion of depreciation titled *How To Treat Depreciation Carried Forward To Your New Property* online at 1031TaxPak.com.

Multi-Asset Exchanges. An exchange is only reported as a multi-asset exchange if you sold *and* received more than one group of like-kind properties. For example, if you exchanged a hotel/restaurant for another hotel/restaurant, your exchange involves exchanging the land and building (which is one 'group'— real estate) as well as furniture, kitchen equipment, etc. (which is another 'group'— personal property). Very few exchanges are multi-asset exchanges, but they involve special reporting rules. If you have questions about this topic, please call us or see section 1.1031(j)-1 of the Treasury Department Regulations at 1031TaxPak.com.

Using the TaxPak Example

Now let's crunch some numbers! To illustrate the method for completing Part III of Form 8824, we included an example that will make these concepts more understandable and help you successfully report your 1031 exchange to the IRS.

We start with a fairly typical 1031 exchange where the taxpayer sold one property and purchased a new one for a higher price. We call this ***buying up***. The main example that follows is a buy-up.

> ***Buying Up*** *– When the New Property has a purchase price that is higher than the sale price of your Old Property.*
>
> ***Buying Down*** *– When the New Property has a purchase price that is lower than the sale price of your Old Property.*

Within our example we have included illustrations of sample WorkSheets so you can see actual calculations. Your 1031TaxPak includes blank WorkSheets for the numbers in your own exchange. The individual WorkSheets flow together in a larger calculation, so they will be *most helpful when completed in order.*

1031TaxPak Example

On December 20, 2013, Fred and Sue Jones sold a rental house in Vail, CO, for $100,000. They originally bought this house on January 10, 2001 for $47,000, and spent $3,000 on remodeling in 2004. They have taken $18,456 in depreciation. They still owe $40,000 on this house. They did a 1031 exchange, and on March 12, 2014 they closed on the purchase of their new rental house in Naples, FL, for $125,000, using the proceeds held by *the 1031 Exchange Experts' llc* for their exchange, and got a new loan for $75,000. Fred and Sue had $10,000 of closing costs (real estate commissions, title insurance, etc.) on the sale of their Old Property, and $2,000 of closing costs on the purchase of their New Property. Their New Property was identified to the *1031 Experts'* on February 04, 2014.

Buy-Down Adjustment

NOTE: If you "Bought Down" (your New Property was less than your old one), pay attention to these *Buy-Down Adjustment* boxes throughout. They illustrate the formula differences in a buy-down and adjust the examples to illustrate a buy-down situation. If you bought up like MOST exchangers, IGNORE these blue boxes. If you bought down, you can also download this entire example as a Buy-Down at 1031TaxPak.com.

Old Property
rental house
123 Main Street,
Vail, CO

Old Property

Purchase price on 01/10/2001 = $47,000
Capital improvements = $3,000
Depreciation = $18,456
Sale price on 12/20/2013 = $100,000
Outstanding mortgage = $40,000
Closing costs = $10,000
Exchange proceeds = $50,000

Exchange proceeds = sale price: $100,000; minus closing costs: $10,000; minus mortgage payoff: $40,000 = $50,000.

New Property
rental house
456 Center Street,
Naples, FL

New Property

Purchase price on 03/12/2014 = $125,000
Exchange proceeds used = $50,000
New loan = $75,000
Closing costs = $2,000
Identification date = February 04, 2014

Buy-Down Adjustment

If you bought down, make these two modifications to the details of the transaction above to create an example for 'buying down.'

Purchase price on 03/12/2014 = $80,000

New loan = $40,000

WorkSheet #1
Calculating the Basis of the Old Property.

To begin, you first need to determine the ***basis*** of the Old Property; this is the starting point for calculating the gain from the sale of your Old Property. The first component of the basis is the original cost of your Old Property. In order to calculate the ***adjusted basis***, items like ***capital improvements*** increase the basis and ***depreciation*** decreases the basis.

Basis *– The amount of an individual's investment in the property for tax purposes.*

Adjusted Basis *– The basis of your property adjusted for items like* capital improvements *and* depreciation.

Capital Improvements *– An addition to, or partial replacement of, property that adds to its value. These improvements lengthen the time you can use it or adapt it to a different use. For example, replacing and upgrading windows, or changing a warehouse into office space.*

Depreciation *– An annual income tax deduction that allows you to recover the cost or other basis of certain property over the time you use the property. It is an allowance for the wear and tear and deterioration of the property.*

WorkSheet #1 is used to determine the adjusted basis of the Old Property you sold. **IRS Publication 551** discusses basis calculations in more detail. You can download this publication at 1031TaxPak.com.

Buy-Down Adjustment

WorkSheet #1 - no adjustment

WorkSheet #1 - Calculation of Basis

A. Original purchase price		$ 47,000
B. ADD: Increases to basis		
Capital improvements to your property	$ 3,000	
Assessments against your property		
Casualty losses - the costs of repairing your property		
Other -		
C. Total increases to basis (Sum of "B")		3,000
D. SUBTRACT: Decreases to basis		
Insurance proceeds received from casualty		
Depreciation deductions	18,456	
Other -		
E. Total decreases to basis (Sum of "D")		18,456
F. Adjusted basis (Line A + Line C - Line E)		31,544

WorkSheet #2
Calculating the Exchange Expenses.

The next step is to compile your ***exchange expenses***. They're the costs that you paid to sell your Old Property and purchase the New Property. To find these costs, look at both ***settlement statements*** from the sale of the Old Property and the purchase of the New Property.

Exchange Expenses *– The closing costs incurred in a 1031 exchange to sell the Old Property and buy the New Property. For example: real estate commissions, legal fees, title insurance, etc.*

Settlement Statement *– This is the document prepared to outline the flow of money in a real estate closing. It begins with the sale/purchase price, then lists all the expenses and credits for the buyer and seller. Often a HUD-1 form is used.*

WorkSheet #2 is used to consolidate and compute the exchange expenses. In this WorkSheet, we give you the corresponding ***HUD-1*** line numbers for each expense.

WorkSheet #2 - Calculation of Exchange Expenses

			HUD-1 Line #
A. Exchange expenses from sale of Old Property			
Commissions	$ 6,000		700
Loan fees for buyer	1,000		800
Title charges			1100
Legal fees			1107
Title insurance	1,000		1108
Recording fees & transfer costs	500		1200
Tax & doc stamps and transfer taxes			1200
Additional Charges -			
Survey costs	450		1300
Pest inspections	500		1300
Courier fees	50		1300
Exchange fees to the QI	500		1300
B. Total exchange expenses from Old Property		$ 10,000	
C. Exchange expenses from purchase of New Property			
Commissions			700
Loan fees paid by you for seller			800
Title charges			1100
Legal fees	1,000		1107
Title insurance			1108
Recording fees & transfer costs	500		1200
Tax & doc stamps and transfer taxes			1200
Additional Charges -			
Survey costs			1300
Pest inspections	500		1300
Courier fees			1300
Exchange fees to the QI			1300
D. Total exchange expenses from New Property		2,000	
E. Total exchange expenses (Line B + Line D)		12,000	

Buy-Down Adjustment

WorkSheet #2 - no adjustment

Some expenses are not considered exchange expenses. The HUD-1 line numbers and the expenses that are excluded from exchange expenses can be found in **Table 1 - Allocation of Settlement Costs** on our web site at 1031TaxPak.com.

HUD-1 *– A federally required form that must be used in real estate closings that involve lender financing. It is so universally used that it is often used as the settlement statement, even when it's not required.*

WorkSheet #3
Basic Fact Gathering on the Old *Property.*

Now that we've completed the complicated calculations, we're ready for some basic fact gathering. These facts will be used to prepare Form 8824.

WorkSheet #3 compiles the information you need about your Old Property, including the ***fair market value*** of the property you sold. Form 8824 uses the term 'fair market value' to mean the sale price of your Old Property.

Fair Market Value (or FMV) *- The IRS term for the sales/purchase price. Most of the time, the sales/purchase price and fair market value are the same number. They differ if you sold your Old Property or bought your New Property for a price that is significantly higher or lower than what the property is really worth. While this makes for interesting court cases, it seldom happens in normal circumstances. If you are one of those affected by this, feel free to call us at 866-694-0204.*

WorkSheet #3 - Information About Your Old Property

A. Description of Old Property	RENTAL HOUSE
B. Address	123 MAIN ST., VAIL, CO
C. Date Sold	12/20/2013
D. Adjusted basis of Old Property from WorkSheet #1 (Line F)	31,544
E. Fair market value or sales price	100,000
F. Date Old Property was originally purchased	01/10/2001

Buy-Down Adjustment

WorkSheet #3 - no adjustment

Buy-Down Adjustment

WorkSheet #4
(Line E) = $80,000

REMEMBER: you can skip these boxes if you didn't buy down.

WorkSheet #4
Basic Fact-Gathering on the New *Property.*

WorkSheet #4 compiles the information you need about your New Property. Again, fair market value is the IRS term for "purchase price."

The ***identification date*** (line "D" below) for your New Property is the date that you submitted your 45-day identification form to us – whether you faxed or mailed it to us. If you mailed it to us, use the postmark date.

Identification Date *– The date you sent your written list to us identifying the property(ies) you were planning to purchase. You probably used the 45-Day Identification Form. If you did not complete this form, and you purchased the property before Day 45, then the* ***closing date*** *of your New Property IS the identification date.*

WorkSheet #4 - Information About Your New Property

A. Description of New Property	RENTAL HOUSE
B. Address	456 CENTER ST., NAPLES, FL
C. Date purchased	03/12/2014
D. Date New Property was identified	02/04/2014
E. Fair market value or purchase price	125,000

WorkSheet #5
Calculating the Debt on the Old and New Properties.

> ***Debt*** *– Any liability that is associated with the Old or New Properties.*

The last bit of information you need to prepare Form 8824 is the amount of ***Debt*** that was paid off on the Old Property and the amount of new debt you have on the New Property.

When is the liability associated with the property? Most often, the property itself is the security for the loan, clearly making it associated with the property. But it is not necessary that the debt be a lien against the property. For example, payments made on unsecured debt to a friend or relative is considered debt as long as the debt is related to the property. Also considered debt are payments made to your bank for advances on a credit line where the money is used for the property.

> ***Loans Assumed*** *–*
>
> *Can be:*
>
> *1. Any liability that the 'other party' took over on your behalf,*
>
> *OR...*
>
> *2. The amount of the outstanding mortgage that was paid off with the sale proceeds from your Old Property,*
>
> *OR...*
>
> *3. The amount of the mortgage on your New Property.*

However, payments to yourself to repay money you put into the property *are not debt.* Neither are advances on a credit line secured by the property that were used for some purpose other than the property.

When referring to the debt associated with your Old and New Properties, the IRS uses the term ***loans assumed***. Don't let this confuse you. Just walk through our WorkSheets and you will determine the correct amounts for these items on Form 8824.

WorkSheet #5 is used to record the affects of debt on your exchange.

WorkSheet #5 - Debt Associated with Your Old and New Property

A.	Loans assumed by other party on your Old Property or debt paid off on the Old Property	$ 40,000
B.	Loans you assumed on your New Property or new debt on the New Property	$ 75,000

Buy-Down Adjustment

WorkSheet #5
(Line B) = $40,000

WorkSheet #6
Calculating the Net Cash Received or Paid.

Next we calculate the net amount of ***cash*** that was paid or received. WorkSheet #6 does this. In some cases the WorkSheet shows that you received cash when in fact the cash was used to pay closing costs. Don't worry, this gets factored out later.

> ***Cash*** *– The actual money that, after your exchange was complete, was either paid out of your pocket or received by you. Simply put: "after the dust has settled, the amount of money that you ended up paying or receiving."*

Buy-Down Adjustment

WorkSheet #6
(Line A) = $80,000
(Line B) = $40,000
(Line C) = $40,000
(Line G) = $20,000

WorkSheet #6 - Calculation of Net Cash Received or Paid

A. Purchase price of New Property from WorkSheet #4 (Line E)	$ 125,000	
B. SUBTRACT: New debt on the New Property from WorkSheet #5 (Line B)	75,000	
C. Net cash paid for the New Property (Line A - Line B)		$ 50,000
D. Sales price of the Old Property from WorkSheet #3 (Line E)	100,000	
E. SUBTRACT: Debt paid off on the Old Property from WorkSheet #5 (Line A)	40,000	
F. Net cash received from the Old Property (Line D - Line E)		60,000
G. Total net cash received, if Line F is greater than Line C (Line F - Line C) (otherwise, write "0")		10,000
H. Total net cash paid, if Line C is greater than Line F (Line C - Line F) (otherwise, write "0")		0

WorkSheet #7 – Calculating Line 15 on Form 8824.

We are near the end! To finish our example, we need to make detailed calculations that will be used to complete **Lines 15 and 18** on Form 8824. To do these calculations, we will refer to the work already completed in WorkSheets 1-6. At the conclusion of our example we will also work through the line-by-line completion of Form 8824 in WorkSheet #9.

For most exchanges, your calculations on Form 8824 will begin on **Line 15.** In simple terms, **Line 15** is calculating the value of everything you received as part of the exchange in addition to your New Property. For example, it factors in any other property received or debt assumed. It also factors in the net effect of any exchange expenses that were incurred during the exchange.

The purpose of WorkSheet #7 is to determine if you have any taxable gain. The IRS calls this gain ***boot***. Boot can come from two sources: 1) cash you received or 2) net debt relief. In other words, *cash boot* or *debt boot.*

***Boot** – The IRS word for the gain that is taxable. It can either come from the cash you received in the exchange OR the net amount of debt relief that came from your exchange.*

The most common type of cash boot occurs when you take cash out of the exchange. Cash boot also occurs when there is cash left over at the end of the exchange. It is possible to have cash boot even though you didn't receive any cash.

For example, if you had $1,000 in repairs on your Old Property that were paid at closing, the IRS considers this $1,000 'boot' because it 'came to you.' In other words it is taxable, although in this case you can take a deduction on your tax return for $1,000 in repair expenses. So in the big picture, you do have cash boot (even though you didn't receive the cash personally), but you don't have a tax liability. The moral here is that if your calculations show that you have boot, don't panic. In your overall tax picture, you may not need to pay tax on this amount.

WorkSheet #7 - Calculation of Form 8824, Line 15

A. Net cash received from WorkSheet #6 (Line G)		$ 10,000
B. Debt paid off on Old Property from WorkSheet #5 (Line A)		40,000
C. Debt on your New Property from WorkSheet #5 (Line B)	$ 75,000	
D. ADD: Net cash paid from WorkSheet #6 (Line H)	0	
E. Total (Line C + Line D)		75,000
F. Net debt relief, but not less than 0 (Line B - Line E)		0
G. Boot received (Line A + Line F)		10,000
H. Total exchange expenses from WorkSheet #2 (Line E)		12,000
I. Lesser of boot or exchange expenses (Lesser of Line G or Line H)		10,000
J. Total boot in excess of exchange expenses (Line G - Line I)		0

Carry to Line 15, Form 8824

Buy-Down Adjustment

WorkSheet #7
(Line A) = $20,000
(Line C) = $40,000
(Line E) = $40,000
(Line G) = $20,000
(Line I) = $12,000
(Line J) = $8,000

Net ***debt relief*** occurs when the debt you paid off on the Old Property is less than the new debt on the New Property. However, the story doesn't end here. Contrary to some, this does not automatically result in debt boot. Additional cash from any other source that you put into the exchange for the purchase of the New Property offsets the debt that was paid off on the Old Property. Therefore, if the amount of new debt plus the additional cash put into the exchange is higher than the debt that was paid off on the Old Property, you do not have debt boot.

> ***Debt Relief*** *– The net amount of debt that was paid off in your exchange. The amount of taxable debt relief is affected by the amount of additional cash that you put into the exchange.*

WorkSheet #8 – Calculating Line 18 on Form 8824.

On Form 8824, **Line 18**, you are asked to calculate the basis of the Old Property given up. This calculation also leads to determining the basis of your New Property. The basis of your New Property equals the basis of your Old Property, plus the buy-up (or increase) to your New Property, plus the sum of your exchange expenses.

WorkSheet #8 works through this calculation for you.

WorkSheet #8 - Calculation of Basis of New Property for Form 8824, Line 18

A. Basis in your Old Property from WorkSheet #1 (Line F)			$ 31,544
B. Total exchange expenses from WorkSheet #2 (Line E)	$ 12,000		
C. SUBTRACT: Boot received from WorkSheet #7 (Line G)	10,000		
D. Exchange expenses not used, not less than 0 (Line B - Line C)		2,000	
E. Loans on your New Property from WorkSheet #5 (Line B)	$ 75,000		
F. ADD: Net cash paid from WorkSheet #6 (Line H)	0		
G. Amount you put into New Property (Line E + Line F)		75,000	
H. Debt paid off on Old Property from WorkSheet #5 (Line A)		40,000	
I. Net increase in your investment (Line G - Line H)			35,000
J. Basis in New Property (Line A + Line D + Line I)			68,544
			Carry to Line 18, Form 8824

> ***Buy-Down Adjustment***
>
> *WorkSheet #8*
> *(Line C) = $20,000*
> *(Line D) = $0*
> *(Line E) = $40,000*
> *(Line G) = $40,000*
> *(Line I) = $0*
> *(Line J) = $31,544*

Last step if you are buying up! (and just one more if buying down!) Now it's time to fill in the blanks on Form 8824. In WorkSheet #9, we have given you a quick reference to complete this final task. The only new calculations at this point are the realized and recognized gains. **Line 19** of Form 8824 calculates realized gain. Realized gain is the actual amount of 'profit' or gain you received from the sale of your Old Property. It is not how much gain you pay tax on – remember: that is called *recognized gain.*

WorkSheet #9 - Completing Form 8824

Line 1	WorkSheet #3 (Line A)	RENTAL HOUSE
Line 2	WorkSheet #4 (Line A)	RENTAL HOUSE
Line 3	WorkSheet #3 (Line F)	01/10/2001
Line 4	WorkSheet #3 (Line C)	12/20/2013
Line 5	WorkSheet #4 (Line D)	02/04/2014
Line 6	WorkSheet #4 (Line C)	03/12/2014
Line 7	Check the appropriate box	
Lines 8-11	See Page 6 of the Guide Book	
Lines 12-14	Complete if other property is involved	
Line 15	WorkSheet #7 (Line J)	0
Line 16	WorkSheet #4 (Line E)	125,000
Line 17	**ADD:** Line 15 and 16	125,000
Line 18	WorkSheet #8 (Line J)	68,544
Line 19	**SUBTRACT:** Line18 FROM Line17	56,456
Line 20	Smaller of Line 15 or 19, but not less than 0	0
Line 21	If buying down, then WorkSheet #10 (Line C)	
Line 22	**SUBTRACT:** Line 21 FROM Line 20, but not less 0	0
Line 23	**ADD:** Line 21 and Line 22	0
Line 24	**SUBTRACT:** Line 23 FROM Line 19	56,456
Line 25	**ADD:** Line 18 and Line 23, then **SUBTRACT:** Line 15	68,544
Line 26-38	Not applicable to 1031 exchanges	

Buy-Down Adjustment

WorkSheet #9

Line 15 = $8,000
Line 16 = $80,000
Line 17 = $88,000
Line 18 = $31,544
Line 20 = $8,000
*Line 21 = $8,000**
Line 23 = $8,000
Line 24 = $48,456
Line 25 = $31,544

WorkSheet #10 explains this adjustment

In our example, the realized gain is the purchase price of Fred and Sue's New Property ($125,000) minus their basis in the property calculated on **Line 18** ($68,544). Their realized gain is $56,456 ($125,000 minus $68,544). Their recognized gain is calculated on **Line 20.** Because it is zero, the realized gain is equal to their ***deferred gain***. This always happens when you are buying up and have reinvested all the cash from your Old Property into the purchase of your New Property.

Deferred Gain *– The amount of realized gain that is rolled forward into your New Property. No tax is paid at this time on the deferred gain.*

This is the goal of doing a 1031 exchange: deferring the capital gains tax due when you sell your Old Property. This is your 'deferred' 1031 exchange gain.

The amount of this deferred gain actually makes sense when you think about what happened: you sold your Old Property that has a basis of $31,544 for $100,000. This resulted in a gain of $68,456. When you take this gain and subtract the costs incurred to sell the Old Property and to buy the New Property of $12,000, you arrive at the same deferred gain ($56,456) that is calculated on **Lines 19** and **24** of Form 8824.

If you did NOT buy-down, turn the page now . . . .

Buy-Down Adjustment

One more step if you are Buying Down...

In our buy-down example, the realized gain is the fair market value of the property received calculated on **Line 17** ($88,000) minus your basis in that property calculated on **Line 18** ($31,544). Your realized gain is $56,456 ($88,000 minus $31,544). The amount of the deferred gain actually makes sense when you think about what happened: you sold your Old Property that has a basis of $31,544 for $100,000. This resulted in a gain of $68,456. When you take this gain and subtract the costs incurred to sell the Old Property and buy the New Property of $12,000, and subtract the $8,000 of recognized gain calculated on **Line 23**, you arrive at the same deferred gain of $48,456 that is calculated on **Line 24** of Form 8824. The amount of your recognized gain also makes sense: you bought down by $20,000 (from $100,000 to $80,000), but you had closing costs of $12,000. So, the net taxable amount is $8,000 ($20,000 minus $12,000).

WorkSheet #10 – Calculating Depreciation Recapture (FOR BUYING DOWN ONLY)

Because you have a taxable gain, complete WorkSheet #10 to figure the character of the gain. The character of the gain determines which tax rate (recapture or non-recapture) you use to calculate your actual tax liability. The federal recapture tax rates are higher than non-recapture rates because the IRS allows you to offset ordinary income by reporting depreciation in the prior tax years while you held the property.

WorkSheet #10 for Buy-Down only

WorkSheet #10 – Calculation of Recapture for Form 8824, Line 21

A. Depreciation taken in prior years from WorkSheet #1 (Line D)	$	18,456
B. Taxable gain from WorkSheet #7 (Line J)	$	8,000
C. Total Recapture (Lesser of Line A or Line B)	$	8,000

Carry to Line 21, Form 8824

Congratulations!

You've conquered the task of calculating your exchange! Now send your signed and completed 2-page 8824 Form along with your tax return to the IRS.

We hope this information and the WorkSheets provided are helpful. If you got stumped along the way or have follow-up questions, contact us at **taxpak@expert1031.com**. Or call us 24/7, nationwide toll-free, at **866-694-0204**. As always, *the Experts'* are available to assist you.

Our goal is to refine and improve 1031TaxPak for future exchangers. If you have any input or feedback for us, we'd love to hear it at taxpak@expert1031.com.

Additional Issues:

Possible circumstances that may affect the reporting of your exchange

Which Tax Year to Report Your Gain

The IRS calls recognized gain 'boot.' There are two types of boot: *debt boot* and *cash boot*. Both are taxable.

Where does the term 'Boot' come from? *Subscribe to our* TEE-Shot *emails* (TEE-Shots.com) *and see #68 in the archive. TEE-Shots are short periodic emails with IRS updates, new court rulings and brief 1031 articles about exchanges in general. (T.E.E. stands for "**T**ips from the **E**xchange **E**xperts').*

Debt boot arises when the mortgage paid off on your Old Property was greater than the combination of the new loan and any additional investments in the New Property. This gain is generally taxable in the same year you report the 1031 exchange.

Cash boot is cash that you receive as part of the sale of your Old Property. This cash either came to you at the sale closing of the Old Property, or was left over at the end of the exchange. In either case, the gain is taxable to you in the same tax year that you receive it. For most exchangers, this happens within the same year.

If you received cash at the end of your exchange, and it was in a different tax year than your sale, things get a little more complicated. First, because you received cash proceeds from the sale in a subsequent tax year, the tax on that cash is automatically subject to ***installment sale*** rules. This means you have to report the cash *as being received in that subsequent year, **not** the year that the Old Property was actually sold.*

> ***Installment Sale*** *– A tax situation where the proceeds or cash from the sale of property is received in two or more consecutive tax years. Special IRS rules apply for installment sales.*

You can 'elect out' of installment sale treatment by filing a statement with your tax return stating that you are electing out. If you do so, the gain on the cash boot will be taxable in the year that the sale occurred. You must file your statement to 'elect out' with a timely filed tax return for the year that the sale occurred. You can extend the due date for your tax return from April 15 to October 15 by filing an extension. This will give you the benefit of time to determine the best way to report your gain.

Example:

You sold your Old Property as part of a 1031 exchange in late 2013 and bought the New Property in 2014. You had $10,000 of proceeds left over that you received in cash after your 180-day exchange period ended in 2014. These proceeds would normally be reported as capital gain proceeds of $10,000 on your tax return for 2014 based on the installment sale rules. However, if you elect out of installment sale reporting on your 2013 tax return, you would report $10,000 of additional proceeds (cash boot) on your 2013 return.

Considerations for Reverse Exchanges

In a 1031 exchange you are not allowed to be the title owner of both the Old and New Properties at the same time. But sometimes you need to buy the New Property before selling the Old Property. Because of this, the IRS has sanctioned a procedure called a ***reverse exchange***, a process devised to buy the New Property *before* you have sold the Old Property. In a reverse exchange, the Qualified Intermediary arranges to purchase the New Property and hold it for you until you can sell your Old Property. After the sale of your Old Property, you then buy the New Property from the Intermediary, completing your exchange.

> ***Reverse Exchange*** *– A procedure used in exchanges where the New Property is purchased before the Old Property is sold. The Intermediary becomes the title holder of the New Property for a period of time. Reverse exchanges have special tax reporting considerations.*

For purposes of Form 8824, you report a reverse exchange the same as if you had exchanged properties in the normal order: first the sale, then the buy. So when you fill out the form, you report the sale of your Old Property to the buyer and the acquisition of your New Property from the seller, disregarding the fact that the seller is your Intermediary. For example, on Form 8824, **Line 6**, the date you actually received the like-kind property is the date you bought the New Property from the Intermediary. It should always be a date after the sale of your Old Property reported on Form 8824, **Line 4**.

There are other tax implications that result from a reverse exchange as well. For example: the Intermediary *is the title owner* of the property during the course of a reverse exchange. Therefore, the IRS requires that the Intermediary file a tax return for any tax-year that it owns the property. If you are doing a reverse exchange with the *1031 Experts'*, we file this return. We provide this service, and it is included in your exchange fee.

Even though we file this tax return, you may also have reporting issues to consider during the time we own the property. Your tax return could be impacted differently depending on which of the two possible ways the reverse exchange was structured.

1. If the New Property was leased to you while the Intermediary owned it, you will be responsible for the collection of rent from your renters and payment of expenses related to the property. This income and expense must be appropriately reported with your tax return on ***Schedule E*** in the year incurred. Amounts that you pay to us in order to make the mortgage payments are typically considered *rent paid to us* per the lease agreement, and are deductible on your tax return.

> ***Schedule E*** *– The IRS tax form used to report the income and expenses from rental property. It is included with Form 1040 when reporting your taxes to the IRS.*

2. If the New Property was not leased to you (sometimes there are technical reasons why a property might not be leased), then the collection of rents and payment of expenses are our responsibility and will be reported on the return that we file. Any money you advance to us is treated as a loan, so those funds are not deductible by you at this time. The interest associated with this loan is not deductible either. Don't worry, these deductions are not lost! Eventually you are allowed to claim a deduction for these amounts once the exchange is completed.

Other Exchange Reporting Resources Available at 1031TaxPak.com

In preparing 1031TaxPak, our objective was to provide you with an easy-to-follow guide that would simplify the process of reporting your exchange. The information in this GuideBook covers the reporting issues that arise in the majority of all 1031 exchanges.

We realize there are other reporting issues that occur in more complex exchanges. To avoid over-complicating TaxPak, we decided to not discuss these unique circumstances in this GuideBook—but we haven't ignored them either. Instead, we created 1031TaxPak.com, where you can access the information you need for these particular issues.

If these issues (discussed briefly below) apply to you, logon to 1031TaxPak.com. There you will find more detailed discussions and guides to these issues. If internet access is not available, call us nationwide toll-free at **866-694-0204**, and we can arrange to have these additional materials delivered to you on paper.

More 1031TaxPak Online

• ***Buy-Down Example.*** The sample exchange in this GuideBook works through a very common situation where the investor exchanges into a property of higher value than the one that was sold. For exchangers who bought property that was *less expensive* than what they sold, the examples and WorkSheets included in TaxPak require additional explanation. If you bought down in your exchange, you can download this ***entire TaxPak example as a Buy-Down*** from 1031TaxPak.com.

• ***How to treat depreciation carried forward to your New Property.*** In a 1031 exchange, you roll forward capital gain (which may include depreciation you've taken) into the New Property. We explain how to treat this depreciation in your ongoing ownership of the New Property, in both buy-up and buy-down exchanges.

• ***Allocation of basis between land and improvements.*** You may need to adjust your treatment of ongoing depreciation to account for the differing values of land and improvements included in your property. We explain what this means and offer suggestions on how to treat it for tax purposes.

• ***How to report depreciation*** on both your Old and New Property when you do a 1031 exchange.

• ***Handling Contract Notes (Seller Financing).*** If you carried financing on the sale of your Old Property, 1031TaxPak.com explains how this is treated for tax purposes.

• ***When to file Form 4797.*** If the Old Property was used as business property, you will also need to file Form 4797 with your tax return. Download this form at 1031TaxPak.com, where we explain when and how to use this form.

• ***When to file Schedule E.*** If either your Old or New Property was used as rental property, you will need to file a Schedule E with your tax return. We explain more about how to handle reporting issues for rental property.

• ***Allocation of Settlement Costs in a 1031 Exchange.*** This table shows how settlement costs are allocated between property costs, loan costs and deductible items.

• ***Tax Changes affecting 2013 Tax Returns.*** During the year there may be changes that could affect how you report your 1031 exchange. If this happens, we discuss them here.

That's it! Have a great day!

The 1031 Exchange Experts LLC
National Qualified Intermediaries