

Commercial Notes

THE ACHTERMANN COMMERCIAL
LENDING GROUP LLC

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Your 1031 Exchange - The Fifth & Final Edition
Advanced 1031 Issues



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Common Ownership Problems

Any tax paying entity can do a 1031 Exchange, including C corporations, S corporations, partnerships and limited liability companies (LLCs). Remember, the taxpayer on the old property must be the same taxpayer on the new property.

The most common ownership problem is that owners often don't know how they hold title to the property. If two or three people own a property, they may call each other partners while they legally hold title to the property as tenants in common, but file a partnership tax return to report the income to the IRS. How they file

their taxes is critical in the exchange.

Another common ownership problem arises when an investment property is owned by an LLC or partnership. The decision has been made to sell the investment property, and some of the partners wish to do an exchange, while others wish to take the cash.

In this situation, a well-intentioned attorney or CPA may advise dissolving the entity so that each owner can choose his own course of action. However, a 1031 Exchange requires that the taxpayer selling the old property be the entity which completes the ex-

change by purchasing the new property.

Keep in mind that the property must also be held in the same name for at least a year and a day. If the entity is dissolved before the exchange, the IRS could argue that the property was held for resale rather than investment, since it was held in the partner's individual name for only a few days from the time of the "buy" through the distribution, to the sale. Ownership issues can be a real minefield for an exchange.

Please call a professional QI before you enter the exchange process for

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Rates Currently Available through
The Achtermann Commercial
Lending Group, LLC

**Minimum Loan \$500,000
Max \$5,000,000
NO BALLOONS!**

25 - 30 years amortization and term.

80% MAX Loan-to-Value,
with Fixed period options
from 1 to 15 years.

(Add 0.15% to loans over 75% LTV)

DSC ratio 1.20 times

Rate	Fixed Period	Am/Term
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7.340%	3 years	30/30
6.930%	5 years	30/30
6.980%	7 years	30/30
7.030%	10 years	30/30
7.730%	15 years	15/15

MARKET INTEREST RATES

Bank Prime Rate

04/05/06	7.75%
05/10/06	8.00%
06/09/06	8.00%
07/20/06	8.25%
08/16/06	8.25%
09/18/06	8.25%
10/16/06	8.25%

1 Year CMT (Treasuries)

06/19/06	5.23%
06/23/06	5.27%
07/05/06	5.29%
07/20/06	5.28%
08/16/06	5.06%
09/18/06	5.04%
10/16/06	5.05%

5 Year CMT (Treasuries)

06/19/06	5.12%
06/23/06	5.21%
07/05/06	5.19%
07/20/06	5.13%
08/16/06	4.81%
09/18/06	4.77%
10/16/06	4.76%

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Your 1031 Exchange the Final Edition

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individualized consultation.

Refinancing 1031 Property

There is a risk to refinancing the property to be sold because the IRS has ruled that cash proceeds refinanced immediately prior to closing an exchange constitutes taxable boot. The rule of thumb in refinancing before the exchange is: don't. You can refinance the newly purchased property immediately after the exchange is completed.

Owner Carry Financing in 1031 Exchanges

If you carry back a note on your sale property, the IRS will treat this note as taxable. As the payments on the note come to you, the principal portion of the payment is subject to the capital gains tax, and the interest portion is subject to ordinary income tax. How can you prevent this note from being taxable? First, the note should be payable to the QI, which puts the note into the exchange. The note must then be converted to cash before you can buy your new property. How do you turn the note into cash? There are three ways. Number one is to get the seller of the new property to agree to take the note as part of the purchase of the new property. As a practical matter, you almost never see this. Number two is to find someone to buy the note.

Unfortunately, because the note is unseasoned, (i.e., it's a brand new note) any buyer of that note will demand a large discount. Number three is that you, as the property seller, buy the note from the QI for face value, and the QI assigns the note back to you. Because you bought the note from the QI at face value, as you receive the principal payments, they're tax free return of basis to you. You will pay income tax on the interest on the note as you receive it, but the principal payments are tax-free. Meanwhile, in your exchange account, the QI is holding cash that can now be used to purchase the new property.

Reverse Exchanges

The complete handbook on section 1031 is available by e-mail request. Just e-mail Machtermann@insight.rr.com requesting a copy and I will e-mail the entire PDF document to you.



Reverse Exchanges

What if you want to buy your new property before selling your old property? If you buy the new property in your name, and subsequently sell the old property, the transaction will not qualify as a 1031 Exchange. This situation calls for a reverse exchange. In a typical reverse exchange, the QI buys and holds (parks) the new property for you until you've closed the sale of your old property. Usually the QI sets up a new entity (call it XYZ) which will purchase the new property for you. You provide XYZ with the funds necessary to purchase the property. You are also responsible for all closing costs on the purchase, but you do not actually take title to the new property – XYZ does. Your loan to XYZ is documented by a promissory note from XYZ to you, a mortgage or deed of trust tying the money to the property, and an exclusive option.

The option provides that you are the only person who can buy the new property from XYZ. When your old property sells, the exchange proceeds go to your QI. XYZ then transfers the property to you and you use your exchange proceeds to buy the new property from XYZ. This completes your 1031 Reverse Exchange.

From the IRS's perspective, the exchange has not started until the old property sells; it just happens that you buy your new property from XYZ, instead of from the original seller. When undertaking a reverse exchange, be careful in the selection of your lender. FHA and Fannie Mae type lenders can be a problem, because they are being asked to lend money to you, but you will not appear on the title for a short period of time. You should seek out a bank or other portfolio lender who will make a bridge loan to you, which can then be converted to long-term financing when XYZ ultimately transfers the property to you.

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Improvement Exchanges

An improvement exchange allows you to buy a fixer-upper with part of the exchange proceeds, and use the rest of the proceeds to make improvements. In an improvement exchange, when you identify the property on the 45-day list, you must also specifically say what improvements you are going to make, and how much they will cost. Like reverse exchanges, the QI will take title to the property while the improvements are being done. The QI cannot transfer the property to you until all of the improvements are completed. You must identify sufficient improvements to use up all your exchange proceeds and complete the work within the 180-day period.

Construction Exchanges

In a construction exchange, you buy bare land with exchange money and build a new building on the land. The QI must buy the land for you and begin construction, but unlike an improvement exchange, you can close out your exchange before the building is completed.



You must still complete your exchange before the 180 days are up. It's important to note, however, that you cannot take title to the land in your own name

at the beginning, or the exchange will be invalid. This is because you would be attempting to use part of the exchange proceeds for just the land, and the remainder for just the improvements, not for a completed, improved property.

Reverse Construction Exchanges

What if you can't get enough new construction completed within 180 days of your sale to equalize and finalize your exchange? In this case, you can do a reverse construction exchange. Here, the QI takes title to the land with money borrowed from you before you sell your old property. Construction on the new property can begin and be well underway so that the construction is almost complete when the old property closes.

Reverse Exchange Recent Developments

The IRS issued a ruling (Rev. Proc. 2002-22), effective September 15, 2000, that provides a "safe harbor" in regard to Reverse Exchanges. One of the significant points in the ruling applies time limits to Reverse Exchanges that are similar to those that had previously only been applied to straight exchanges. Provisions that must be met in order to fall within the safe harbor: **1.** From the date of closing on the new property, you have 45 days to determine a list of properties you want to sell. **2.** Also from the date of closing on the new property, you have 180 days to complete the entire reverse exchange. **3.** Other properties you want to buy or sell as part of the same Reverse Exchange must be identified.

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This is the last installment regarding the topic, 1031 Exchanges. The entire series is available by contacting me at Machtermann@insight.rr.com. As stated earlier, this series of articles is not and should not be considered legal advice and it is highly recommended that you contact legal counsel when you have a question regarding a 1031 Exchange. Rick Mann has provided us insight to this process as has various title companies. Please contact one of them for specific answers to your questions.

Marvin D. Achtermann