Case Study: A Forward Exchange of Real Estate

The Facts

A qualified intermediary (QI) company, Accruit, received an inquiry from some taxpayers, who we will call Mr. and Mrs. Pike, regarding facilitating a real estate exchange. The clients got in touch with Accruit on July 14, 2014.

The Pikes had entered into a contract to sell their ½ interest in a multi-family investment property located in San Francisco, California. The contract called for a closing on August 15, 2014. The sale price was $1,000,000. At this point in time, the Pikes did not know what they might be acquiring as replacement property.

The Problem

They did not want to incur any tax in connection with the sale. Although QIs cannot give tax advice, and we did not, let's assume their basis in the property being sold, the relinquished property, was $600,000 and their joint income was above $250,000 per year. The basis in property is determined by the original purchase price of the property plus the cost of any improvements they added to the property and minus any depreciation they took on the property during their period of ownership. Let's assume they bought the property for $700,000, added $50,000 in improvements and took $150,000 in depreciation to arrive at the basis in the property. Without an exchange they would be looking at taxes as follows:

20% capital gain on the appreciation ($250,000 x 20%)	$50,000
25% recapture of depreciation taken ($150,000 x 25%)	$37.500
Affordable Care Act tax ($250,000 x 3.8%)	$9,500
Approximate effective rate of California capital gain ($250,000 x 9%)	$22,500
Total Potential Tax Liability	$119,500

The Solution: A 1031 Exchange

A tax deferred exchange, in which the Pikes would trade up or even in value and have at least the same new mortgage liability as they had on the relinquished property, would negate the payment of any tax. The applicable forward exchange docs were prepared for the Pikes. They executed and returned these documents consisting of the following:

- Exchanger information form
- Tax deferred exchange agreement
- Qualified escrow agreement for the deposit and holding of the exchange funds
- Assignment of rights in the relinquished property contract
- Copy of the sale contract pertaining to the assignment
- W-9 in connection with the interest to be earned on the deposit of the exchange funds
- Copies of their drivers' licenses

For a non-1031 exchange transaction in California, the settlement agent may have to hold back some of the sale proceeds to cover the state's capital gains liability. However when California taxpayers are selling relinquished property as the first step towards an exchange of property, the client will complete a form 593-C known as a "Real Estate Withholding Certificate" in order to obtain an exemption from the withholding. The QI is then responsible for withholding should the taxpayer not utilize all the funds in the exchange account when they acquire their replacement property.

The Pikes closed on the sale of their property on July 31, 2014, and the amount of $821,377 was wire transferred to their exchange account. Once the relinquished property sale was complete they needed to provide the following forms in order to complete their acquisition of the replacement property:

- Designation notice within 45 days of the sale identifying up to three potential replacement properties
- Assignment of rights in the replacement property contract
- Copy of the purchase contract pertaining to the assignment
- Disbursement instructions to the QI and the escrow agent for the replacement property purchase

On August 26, 2014, the Pikes signed and returned the designation notice identifying a property in San Mateo, California as their only replacement property. On September 3, 2014, they assigned their rights under the replacement property contract and directed the QI to put down earnest money of $23,250 in connection with the purchase of the new property. On September 11, 2014, the QI was directed to wire transfer the additional sum of $776,414 to the settlement agent and the Pikes acquired the property at that time.

The client's exchange account held an additional $21,176 of non-reinvested proceeds and the Pikes sought a return of that sum. Due to California's withholding requirement, North Star completed a California Real Estate Withholding Tax Statement (Form 593) requiring a hold back and direct payment to the State of 3.33%, or $723. North Star remitted the balance to the Pikes.

The Pike's will file an IRS form 8824 at the end of the tax year to report their exchange transaction.

The Result

With the exception of the small amount of tax pertaining to the funds not needed in the acquisition of the replacement property, the Pikes achieved tax deferral on the sale of their relinquished property - approximately a $112,000 savings which was reinvested in their replacement property.