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1031 Exchange Planning For 2011

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Many of the tax law changes coming about will impact exchange and investment planning in 2011. Several new and pending issues will impact 1031 exchange clients in the coming year. As a result, real estate 1031 exchanges will become even more valuable.

The emphasis in 2010 was on the security of escrow funds. Virginia passed the Exchange Facilitator Act in which we were directly involved. Originated by the Virginia Association of Realtors (VAR), fully supported by us and the Federation of Exchange Accommodators (FEA), the bill was passed and signed by the Governor. This law provides for security of exchanger funds, and directs they be placed in separately identified accounts in a financial institution, that there be liquidity of escrow funds, and there be written exchanger consent of any withdrawals. This law ensures the security of funds for anyone exchanging a property in Virginia or using a Virginia QI. The FEA has continually recommended federal law changes to ensure the security of funds. Primarily as a result of our efforts to get this bill passed, the FEA awarded me their annual President's Award.

Unless Congress acts before the end of 2010, the Bush tax rates will sunset on January 1, 2011. For sellers this means the long term capital gains tax rate on real estate will rise from today's 15% rate to 20%. Also dividends will no longer be taxed at the low rate of 15% but will be taxed at regular income tax rates.

While there was no estate tax in 2010, property was inherited at the deceased owner's basis. Due to existing law, the estate tax will return in 2011 with an exemption of only \$1 million dollars. Important is that all of the 1031 exchange gain that was deferred over the previous years will be forgotten, and heirs will inherit property at the current market value or stepped-up basis. Unfortunately, the federal estate tax is scheduled to return on Jan. 1, 2011, imposing a levy of up to 55% on estates valued at more than \$1 million. If you add up the value of a home, retirement savings accounts, and an IRA or 401k account, you get to \$1 million very quickly.

There will be expanded IRS Form 1099 reporting for rental property owners. The Small Business Jobs Act of 2010 requires, starting with the year 2011, all individuals who own rental property to issue an IRS Form 1099 for payments relating to their rental properties. Now, by definition, "a person receiving rental income from real estate shall be considered to be engaged in a trade or business of renting property." A 1099-MISC form will be required if the property owner

spends \$600 or more per year per recipient. Examples of possible 1099-MISC recipients: gardeners, landscapers, pool cleaners, contractors and repair service providers.

Another new tax increase is coming in 2013. While no regulations have been issued, if you do a 1031 exchange you should be able to defer the impact of this new tax increase. Starting in 2013, “net investment income” of individuals, estates and trusts will be subject to an additional 3.8% tax to the extent the taxpayer’s modified adjusted gross income (MAGI) exceeds threshold amounts. “Net investment income” includes capital gains from sales on investment properties and rentals (property held in a passive activity). Partnerships and S corporations may be impacted because they pass through income to the individual members or shareholders. It will not apply to properties used in an active trade or business or by a C corporation. The income thresholds are \$250K for married couples and \$200K for other taxpayers. The definition of net investment income states “to the extent taken into account in computing taxable income.” Therefore, excluded gain from a principal residence sale under Section 121 should be excluded. Thus, gain deferred under Section 1031 should not be subject to the tax.

A new law provides a provision to study the 1031 exchange industry. The Wall Street Reform and Consumer Protection Act created a new consumer regulator, called the Consumer Financial Protection Bureau (CFPB). The new law requires the Director of the Bureau to conduct a study and report by July 2011 any proposed legislation and/or regulations to protect consumers using exchange facilitators. Any proposed regulations or law should then be implemented within the following two years.

In summary, the overwhelming majority of our clients are rental investment property owners. Each of these provisions alters the landscape for planning. The 1031 exchange is still a powerful provision in our tax code to defer recognizing gain on the sale of investment properties and hopefully not trigger these new tax increases. As many of us in our business say, you should “swap till you drop”.

This publication is designed to provide accurate information on tax-deferred exchanges. The publisher is not engaged in rendering legal or accounting services. If legal or tax advice is required, the services of a competent professional should be sought.