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Follow the Rules, and Don't Skip a Step. We've had IRS 1031 regulations since 1990. There have been a few changes over the years, but the fundamental steps are still in place. Ralph Crandall and Dene Dulin skipped a few of those fundamental steps and paid the price. In a recent court case, *Ralph E. Crandall, Jr. and Dene E. Dulin vs Commissioner of Internal Revenue*, which was decided in February 2011, Crandall and Dulin sold their Arizona investment property and bought a California investment property. The cash from the Arizona sale went into an Arizona title company's escrow account, and was then used to purchase, through a California title company, the replacement property in California. They reported the transaction as an exchange on their 2005 tax return.

Where was the problem? The IRS argued that Crandall and Dulin actually had constructive receipt of the money from the sale. They did not use a qualified intermediary. Further, neither of the escrow arrangements with the title companies limited Crandall and Dulin's right to receive, pledge, borrow or otherwise obtain the benefits of the funds. The taxpayer's own limitation on the use of the funds does not convert the escrow account into a qualified escrow account (Klein v. Commissioner, T.C. memo 1993-491). The regulations are clear: to avoid being in constructive receipt of the funds, a taxpayer may use a qualified escrow account (1.1031(k)-1(g)(3).

The underlying purpose of Section 1031 is to permit the taxpayer to defer gain on "an ongoing investment, rather than ridding himself of one investment to obtain another" (Teruya Brothers, LTD vs Commissioner). So even though the end result was that Crandall and Dulin sold an investment and used the funds to replace their investment, they technically had access to the monies in between transactions. Skipping the qualified intermediary and qualified escrow step cost them their exchange. - Ouch!.

1099 Update In our last newsletter we alerted landlords to new 1099 reporting requirements. H.R. 4 (H.R. 4: Comprehensive 1099 Taxpayer Protection and Repayment of Exchange Subsidy Overpayments Act of 2011) repeals the 1099 reporting provisions that are included in the The Small Business Jobs Act of 2010. HR 4 has been passed by both houses of Congress and has been signed by the President.

Swap Till You Drop Strategy. We have often heard the saying "…nothing can be said to be certain, except death and taxes." Well, with a 1031 exchange we have learned how to defer the capital gains (profit) and 1250 depreciation recapture taxes on investment or business property. Unfortunately, we still haven't figured out how to avoid death (yet).

While death is inevitable, 1031 exchange property holders should rejoice over the answers to three questions under current tax laws:

What happens to the taxes that have been deferred? Will my estate be taxed? What tax basis will my heirs inherit in the 1031 property?

If you die owning a replacement property you obtained through a 1031 exchange, there is no change in the rules. Regardless of how low your tax basis is in the property, there is no tax due. All the taxes on the profit and depreciation recapture you previously deferred when you did the 1031 exchange are forgotten. We have often called this the "ultimate deferral." The property is part of your estate so you may now need to deal with estate taxes.

Due to the Tax Relief Unemployment Insurance Re-authorization and Job Creation Act of 2010 ("Tax Relief Act"), signed into law in December 2010, the estate tax exemption was raised to $5 million dollars. If you are married this exemption may reach $10 million dollars. In other words, if the value of your estate is less than $5 million, then the exemption will cover all of it, and no estate tax will be due. If

it is more than the exemption, then the tax on the excess will be at the top rate of 35%. **These estate tax rules are good through 2012.**

Under the current "Tax Relief Act", our heirs will inherit property we leave them at the current market value, or what is called the "stepped up" basis. Today if your heirs were to immediately sell the property, no tax would be due. As a simple example, I own a rental townhouse worth $500k that I exchanged into many years ago and now have a basis of 100k, giving me a gain of $400k. This gain includes both depreciation I took over all the years and my profit. I pass away and my son inherits this $500k property. His starting basis steps up to today's value of $500k. If my son immediately sells the property, he has a basis of $500k and a sale at $500k, so he has no gain and no taxes due.

We had a client who inherited property years ago and received a stepped up basis, but the property was tied up in estate fights. Once the property was finally sold, there was gain from when he inherited the property to the time of the eventual sale, so our client owed taxes on that gain.

Some of our clients know their heirs do not want the rental properties they have been managing for years. As part of their estate planning, they will ask the family where they want to eventually own property. Clients will sell the rental properties and exchange into a location where they know their heirs will want to own property. For example, they will exchange two smaller rental properties for a new rental beach property or a new rental ski condo that they know their heirs will want to own. When their heirs inherit the property, there are no taxes due.

While we cannot escape death, at least we can escape paying taxes on the property we own. While the "Tax Relief Act" gives us current guidance, it has only moved the 2010 uncertainty out for two years. We can be certain that in 2012 we will have the same political battles over taxes that we saw in 2010 until the "Tax Relief Act" was passed.

8824 Workbook for the 2010 Tax Return is Published. The free complimentary Realty Exchange Corporation 8824 workbook for the 2010 tax return is published and can be found here: http://www.1031.us/8824/IRS8824.htm.