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2013 Capital Gains Tax Changes

Congress averted the 'Fiscal Cliff' by passing The American Taxpayer Relief Act of 2012. But are the changes over? According to the experts, not likely. Are the changes easy to follow? Not exactly...

This act allows the Bush era tax rates to sunset (end) for taxpayers with taxable income above \$400,000 if single, \$450,000 for married taxpayers and \$425,000 for heads of household. The result is 10, 15, 25, 28 and 33% rates remain the same, however there will be an increase for the top earners (\$400-\$450,000) of 39.6% adjusted to inflation after 2013.

All taxpayers will see an increase from 4.2% on earned income to 6.2% up to the Social security base amount with the end of the 2012 payroll tax holiday.

"The hardest thing to understand in the world is income tax".

Albert Einstein

The Reverse - Tool for a Tight Market

Real Estate markets are heating up in many parts of the country. Many investors are very concerned that if they sell they cannot find suitable replacement property and may end up overpaying just to complete their exchange.

Frequently we're asked, "Can I purchase first?" The answer is "Yes".

There is an alternative for those investors with the financial means. It's the Reverse Exchange. While an investor cannot defer capital gain by exchanging into any property they already own, under IRS rules the

The New Capital Gain Rates

A higher capital gains rate of 20% (up from 15%) will also be used for these same top earners.

Medicare Surtax

The 2012 Act also created a new Medicare surtax of 3.8% on net investment income (IRC Section 1411) for individuals earning over \$200,000 and married couples filing jointly earning over \$250,000. Net investment income includes interest, dividends, rental income, capital gains, retirement and partnership income.

The IRS (under **proposed** REG 130507-11) states "to the extent that gain from a like-kind exchange is not recognized for income tax purposes under Section 1031, it is not recognized for purposes of determining net investment income under Section 1411.

Other taxes that investors can defer using IRC Section 1031 when selling investment property in addition to capital gains, are depreciation recapture and applicable state taxes.

intermediary can be used to buy and 'ware house' the replacement property. This gives the investor 180 days from that purchase date to sell their relinquished property. In the unlikely event the investor is unable to sell their property in that 180 days, the intermediary transfers the replacement property to the exchangor. However, there are no capital gains taxes owed as nothing has sold. Though the intermediary fees are higher to facilitate a reverse exchange, more and more investors will weigh this option as markets continue to improve.

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From the Field - What are Other Investors Doing?

A client sold one property that he owned debt free. Using his equity he went to an area of the country where there was considerable inventory of distressed single-family homes that were owned by 1 seller. During the 180-day exchange period the client purchased 20 residential rental properties. Using his substantial cash proceeds he was able make a large down on each property and small loans for the balance.

THE RESULT: He ended up with immediate cash flow in a strong rental market, enough property to have a full time manager on site and ownership in an area where the upside potential exists.

An investor called a few weeks ago. "I've had it. I just got my bank statement and figured out what rate I'm earning on my money. Ridiculous!" The client went on. "I thought I was getting out of real estate but what I want now is some cash flow so I'm back. I found 6 contiguous townhouses that I can buy with the proceeds from the sale of my rental house.

My monthly cash flow will go from \$900.00 a month to almost \$3,000.

He finished his statement, "It would be stupid not to do it."

Most Common Questions...

Financing - an issue?

A common complaint is the time to get loans secured. Fannie & Freddie and bank REO's in particular can be difficult for a buyer, particularly in a §1031 exchange with strict time limits. However, it can be done. Our firm has many clients who have purchased distressed properties to finish their exchange.

Can I take cash out or carry back a Note?

Many clients chose a combination of an exchange, cash and or a Note when selling. Taking some cash out (less than the gain) means paying some portion of the taxes owed but not all. Taking the Note as an installment means taxes will be paid in installments, potentially avoiding the highest tax brackets by receiving a lump sum. The cash is used to exchange into a smaller property, thereby deferring some of their capital gains tax until some point in the future.

Like kind property - still misunderstood by investors

One of the most common misunderstandings is how generous the definition of like kind is under the tax code. The client (exchangor) can roll into anything held for investment or used to produce income. That means just about anything but their primary residence such as a rental house, raw land, apartments & commercial.

No profit, No taxes... True?

Not necessarily. Highly depreciated property could still result in significant taxes. Some investors may have actually lost money during the real estate bubble but should at least talk to their tax counsel to see if they could save taxes by exchanging.

I have to pay the taxes anyway - why not now?

An exchange is very similar in principle to an Individual Retirement Account (IRA). The taxpayer is allowed to defer the taxes owed until some point in the future when they take cash out of the IRA account. With planning the taxpayer can be careful to avoid the higher tax brackets associated with large distributions of income, using only what they need. That coupled with the future value of the dollar may make a big difference in the net for the taxpayer. Many experts believe inflation is inevitable which means even less value to the dollar of taxes deferred until the final sale.



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When can the Exchangor have Access to Excess Proceeds?

Once a 1031 exchange is entered into, funds from the sale of the relinquished property are transferred to the Qualified Intermediary (QI). The principle is similar to an Individual Retirement Account (IRA). The IRS allows investors to treat investment real estate (farm or ranch, land, business or residential rental) as one continuous investment without paying capital gains taxes as long as they 'roll their equity' into a different qualifying investment. The key - they cannot control the funds (constructive receipt). The QI was created under the IRS code to act much like the IRA holder, providing the documentation and significant restrictions to satisfy the tax code.

What does that mean?

From the closing date of a sale, the taxpayer has 45 days to identify in writing their replacement property. Under no circumstances can the Intermediary release sale proceeds to the investor during this Identification period. This is true even when the investor has identified just one property and has closed on it during the 45 days but still has residual proceeds with the Intermediary. In this example, the residual proceeds can only be returned to the investor the following business day after the 45-day identification period has expired. An early release would cause the exchange to be disallowed and the sale becomes taxable

What if the taxpayer identifies more than one property and purchases only one of the identified properties. They have residual funds and don't want to close on the other identified properties? The IRS maintains because there are other identified properties the Intermediary cannot release any excess monies until the entire 180-day exchange period has expired. Again, to do so would cause the exchange to fail.

Solution

To mitigate this unpopular restriction but still follow the strict IRS mandate, Starker Services advises the exchangor if identifying more than one property to use the words and/or on the identification form. By using the word "or" the taxpayer could list Elm Street or Main Street on the ID form, close on one of the properties and have any residual funds released after the 45 days. This allows the taxpayer who wants to close on just one replacement property to have the added safety of completing the exchange if they are not able to close on their first choice. Otherwise, if the investor lists the properties as Elm Street **and** Main Street the Intermediary would be required to hold any residual funds until both properties have closed (and the 45-day period has expired) or until the entire 180-day exchange period has passed.

This may be one of the most confusing parts of the tax code when it comes to §1031. If you would like more information or to talk about your particular questions please give our office a call or email us at 1031@starker.com.

FOR MORE DETAIL on any of the topics in this newsletter please contact Starker at 800.332.1031 or email 1031@starker.com