

Simulating a Section 1031 tax-deferred exchange of real estate property

If a taxpayer disposes of "property held for productive use in a trade or business or for investment," and acquires replacement property held for use in a trade or business or held for investment, Section 1031 applies, and any capital gain on the transfer is not recognized.

Where the Section 1031 tax-deferred exchange relates to real estate assets in NaviPlan, you can simulate the exchange using buy and sell records along with an expense record to offset the effect on cash flow.

- Note: This simulation assumes that properties are being traded with equal value.

Match the source asset's cost basis to its projected market value

To avoid the exposure of unrealized gains or losses on the sale of the source asset, simply reset its cost basis to match the asset's projected market value as of the sale date. (In this case, the sale date is December 31, 2005.)

- To identify the market value of the asset as of the intended sale date, generate the *Single Asset Detailed* report by going to the **Reports** menu, and then selecting *Net Worth – Single Asset Detailed*.

Single Asset Detailed							
Source Real Estate Asset (Frank/Non-Qualified)							
Married							
Proposed (2005)							
	Market Value (Start)	Interest	Capital Gain	Rental	Buy Amount	Sell Amount	New Cost Basis
Jan 2005	1,000,000.00	0.00	0.00	0.00	0.00	0.00	441,346.15
Feb 2005	1,001,666.67	0.00	0.00	0.00	0.00	0.00	440,384.62
Mar 2005	1,003,333.33	0.00	0.00	0.00	0.00	0.00	439,423.08
Apr 2005	1,005,000.00	0.00	0.00	0.00	0.00	0.00	438,461.54
May 2005	1,006,666.67	0.00	0.00	0.00	0.00	0.00	437,500.00
Jun 2005	1,008,333.33	0.00	0.00	0.00	0.00	0.00	436,538.46
Jul 2005	1,010,000.00	0.00	0.00	0.00	0.00	0.00	435,576.92
Aug 2005	1,011,666.67	0.00	0.00	0.00	0.00	0.00	434,615.38
Sep 2005	1,013,333.33	0.00	0.00	0.00	0.00	0.00	433,653.85
Oct 2005	1,015,000.00	0.00	0.00	0.00	0.00	0.00	432,692.31
Nov 2005	1,016,666.67	0.00	0.00	0.00	0.00	0.00	431,730.77
Dec 2005	1,018,333.33	0.00	0.00	0.00	0.00	0.00	430,769.23
End 2005	1,020,000.00	0.00	0.00	0.00	0.00	0.00	430,769.23
TOTAL	1,020,000.00	0.00	0.00	0.00	0.00	0.00	430,769.23

The value as of Jan 1, 2005 is \$1,000,000.00

Source asset with cost basis reset from original \$500,000 to \$1,020,000

Sell the source asset

With the cost basis now reset to match the asset’s market value as of the projected sale date, go to the **Sale Information** tab, and then enter the sale date. The selling cost should be set to 0%.

Purchase the new asset with an amount equal to the source asset's original cost basis

Go to the **Assets** category – **Real Estate** tab. Click **Edit** to open the *Real Estate* dialog box. Insert a new asset record with the purchase date and purchase amount reflecting the source asset's sale date and original cost basis.

The screenshot shows the 'Real Estate (Details)' dialog box with the following fields and values:

- General Information:** Name: New Real Estate (1031 Transfer), Ownership: Frank, Type: Non-Qualified, Community Property:
- Purchase Info:** Purchase Date: Dec 31 2005, Purchase Amount: \$500,000.00 (circled in red), Portion not depreciable (e.g. land): 10.00%, Annual Depreciation: \$11,538.46 or 39.00 years
- Start of Year Value:** Market Value: \$0.00, Adjusted Cost Basis: \$0.00
- Growth:** Rate: 2.0000%, Standard Deviation: 0.0000%, Override:
- After the current value date, base on:** Start of Year Value
- Current Value (optional):** As of: Dec 31 2005, Market value is: \$0.00
- Additions prior to 2005:** Cost of Additions: \$0.00, Depreciation so far: \$0.00, Annual Depreciation: \$0.00 or 0.00 years

Note: In a like-kind exchange, the carryover holding period for the new asset is based on the holding date of the asset sold. This is not accounted for in this simulation, so the proper capital gains treatment will not be applied should the new asset be sold within one year of its purchase date.

Reset the new asset's market value

The new asset's market value can now be readjusted using the fields under *Current Value (optional)*. Set the *As of* date to the month following the new asset's purchase date. The *Market value is* field becomes editable.

The screenshot shows the 'Real Estate (Details)' dialog box with the following fields and values:

- General Information:** Name: New Real Estate (1031 Transfer), Ownership: Frank, Type: Non-Qualified, Community Property:
- Purchase Info:** Purchase Date: Dec 31 2005, Purchase Amount: \$500,000.00, Portion not depreciable (e.g. land): 10.00% / \$50,000.00, Annual Depreciation: \$11,538.46 or 39.00 years
- Start of Year Value:** Market Value: \$0.00, Adjusted Cost Basis: \$0.00
- Growth:** Rate: 2.0000%, Standard Deviation: 0.0000%, After the current value date, base on: Start of Year Value
- Current Value (optional):** As of: Jan 1 2006 (circled in red), Market value is: \$1,020,000.00 (circled in red)
- Additions prior to 2005:** Cost of Additions: \$0.00, Depreciation so far: \$0.00, Annual Depreciation: \$0.00 or 0.00 years

Expense from cash flow surplus sale proceeds

Because the sale proceeds of the source asset exceed the purchase amount of the new asset (entered at the source asset's original cost basis amount), a surplus of cash results. This surplus cash can be eliminated by using an expense to cancel the effect on the plan's cash flow.

1. Go to the **Expenses** category – **Standard** tab. Click **Insert** and then select **Lump Sum – Other Lifestyle Expense**. The Lump Sum Expense dialog box opens. In the *Source* field, give the expense a descriptive name.
2. Enter the amount to be taken out of cash flow in the *Amount* field, and then synchronize the date with the sale date of the source asset.

Lump Sum Expense

General Information

Member: Frank
Expense Type: Lifestyle Expenses
Source: Cash flow offset for 1031 workaround impact

Amount

Amount: \$520,000.00

Index from 2005

Inflation Rate + 0.00% = 0.00%

Date Effective

Dec 31 2005 (age 48.51)

Retirement Date + 0 years

Frank

Include in Targeted Deficit Coverage

Projection Cancel OK

3. Under *Index from 2005* clear the **Inflation Rate** check box and field.
4. Clear the **Include in Targeted Deficit Coverage** check box, and then click **OK**.