

1031 Exchanges Real Estate Basics

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TITLE TENETS Webinar Series

IRC 1031 Exchanges

Since 1921, the tax code has provided taxpayers who own real property held for investment or use in a business a significant tax advantage – an IRC Section 1031 tax-deferred exchange, often referred to as a 1031 exchange.

A 1031 exchange allows taxpayers holding real property for investment or business purposes to potentially defer all taxes that would otherwise be incurred on a taxable sale of investment or business property.

1031 exchanges are a valuable investment strategy giving taxpayers the opportunity to defer taxes and build wealth in real estate.

Capital Gain Taxes

Four levels of taxes:

1. Depreciation Recapture (25%)
2. Remaining Federal Gain (15%/20%)
3. Net Investment Income Tax (3.8%)
4. State Taxes (0 – 13.3%)

= TOTAL TAXES OWED

Contact your tax advisor/CPA prior to closing and have them provide an estimate of taxes owed if the relinquished property is sold in a taxable sale.



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No gain or loss shall be recognized on the exchange of real property held for productive use in a trade or business or for investment if such real property is exchanged solely for real property of like-kind which is to be held either for productive use in a trade or business or for investment.

Exceptions

- Stock in trade or other property held primarily for sale
- Stocks, bonds, or notes
- Other securities or evidences of indebtedness or interest
- Interests in a partnership
- Certificates of trust or beneficial interest
- Choses in action



Property Held for Sale

- The purpose for which the property was initially acquired
- The purpose for which the property was subsequently held
- The purpose for which the property was being held at the time of sale
- The extent to which improvements, if any, were made to the property
- The frequency, number and continuity of sales
- The extent and nature of the transaction involved
- The ordinary course of business of the taxpayer
- The extent of advertising, promotion of the other active efforts used in soliciting buyers for the sales of the property
- The listing of property with brokers

Allen v. United States

- Taxpayer was not able to prove their intent changed from holding for development to holding for investment.
- Allen purchased property in 1987, and from 1987 to 1995 Allen attempted to develop the property on his own.
- From 1995 to 1999, Allen brought in partners who contributed capital for development.
- In 1999, Allen sold the property to a developer.
- Allen made significant and extensive efforts to develop the property over many years, and failed to substantiate when his actions changed with regard to the property.
- Ultimately, Allen failed to provide any evidence to prove that his intent changed during the time of ownership of the property.

§1031 - Partnership Issues

- **A Partnership/LLC 1031 Exchange Scenario:** A property is owned by a partnership/LLC. Some partners may want the partnership to stay together and do a 1031 exchange; others may want to do their own separate exchange with their portion of the property; others may want to receive cash and pay the taxes owed.
- The fact the partnership owns a capital asset does not mean the partners have an ownership interest in that asset.
- The partners merely own partnership interests.
- Partnership interests are specifically excluded from Section 1031 under section 1031(a)(2)(D).
- Therefore, if a partner wants to exchange, they must convert the partnership interest into an interest in the capital asset owned by the partnership.

§1031 - Partnership Issues

“Drop and Swap” - Involves the liquidation of a partnership interest by distributing an interest in the property owned by the partnership.

After completing the “drop” the former partner will have converted their partnership interest into an interest in the actual property, as a tenant-in-common with the partnership.

The property can then be sold with the former partner and the partnership entitled to do what they wish (sale or exchange) with their respective interests.

“Swap and Drop” - This alternative involves the same two steps, but in the reverse order. The partnership completes the exchange (the “swap”) and then distributes an interest in the replacement property to the departing partner.



§1031 - Partnership Issues

Holding Period Issues:

If the “drop” occurs close in time to the “swap” (or visa versa) there may be a question as to whether the relinquished property (or replacement property) was “held for investment.”

If the “drop” occurs too close to the “swap”, the partner’s exchange may be deemed an exchange by the partnership under the *Court Holdings* case.

The more time that passes between the “drop” and “swap” the better.

§1031 - Partnership Issues

Holding Period Issues:

Numerous federal cases (*Bolker, Mason, Maloney*) provide taxpayer-friendly authority against challenges by the IRS.

Some state tax authorities, such as the Franchise Tax Board (FTB) in California, challenge the federal cases and argue they are not bound by the federal cases.

Changes made in 2008 to the federal partnership tax return (IRS Form 1065) make it easier to detect when a drop and swap transaction has occurred, thus making such transactions more vulnerable to challenge by taxing authorities.

§1031 - Partnership Issues

Partnership Installment Note (“PIN”):

An alternative is known as a partnership installment note (“PIN”) transaction which results in the gain associated with the “boot” is recognized only by the departing partners. In a PIN transaction, instead of receiving cash, the partnership receives an installment note in the amount necessary to cash out the departing partner(s).

The note is transferred to the departing partner(s) as consideration for their partnership interests. If at least one payment under the note is received in the year following the 1031 exchange, the gain associated with the note is taxed under the IRC Section 453 installment method and recognized only when the actual payments are received by the departed partner(s).



Exchange Entities - General

The same tax owner should take title to the replacement property in the same manner they held title to the relinquished property.

- Wife relinquishes, wife acquires
- Smith LLC relinquishes, Smith LLC acquires
- Gemco Corp. relinquishes, Gemco Corp. acquires
- Durst Partnership relinquishes, Durst Partnership acquires
- However, having the vesting the same is only a guideline.
- The key issue is the 'tax owner' of the relinquished property must acquire tax ownership of the replacement property.

Exchange Entities - Exceptions

It is necessary to distinguish between 1) federal tax ownership, 2) state law ownership, and 3) vesting.

A taxpayer who elects taxation as a sole proprietorship (disregarded entity for Federal tax purposes) can sell relinquished property as an individual but acquire replacement property as a single member LLC.

An LLC with two members will be considered a single member LLC if the sole role of the other member is to prevent the other member from placing the LLC into bankruptcy and the limited role member LLC has no interest in profits/losses nor any managing rights.

Related Party

Who is a Related Party?

Four Different Scenarios:

1. Simultaneous Exchange (Swap)
2. Delayed – Selling to a Related Party
3. Delayed – Purchasing from a Related Party
(See Rev. Ruling 2002-83, PLR 9748006)
4. Delayed – Purchasing from a Related Party who is Exchanging
(See PLR 2004-40002)



Related Party-Legal Developments

PLR 201216007 – Related Party Ruling: The non-tax exception to 1031 (f)(4) applies when related parties are also exchanging and receive a limited amount of boot. Each party must hold the replacement property for 2 years and permitted cash boot up to 5%.

PLR 2012120012 – Related Party Ruling: Involves successive exchanges and each taxpayer receives its own 45/180 day time period. Taxpayer had up to 540 days to complete their exchange.

The Malulani Group, Limited & Subsidiary, TC Memo 2016-209 – Taxpayer purchased from a related party and the Court looked at the two taxpayers as a single economic unit.



Like-Kind Property



Like-Kind Property

What Real Property is Excluded?

- Principal residence
- Property held for sale/dealer property

Qualifying Real Property

- Any relinquished real property held for productive use in a trade or business or investment exchanged for replacement real property held for productive use in a trade or business or investment.

Real Property Definition Can be Broad

- Can include raw land, commercial, single family rental (SFR), multi-family, office, industrial, easements, air rights, water rights, vacation homes held for investment under Rev. Proc. 2008-16, fractional ownership, etc.



Creative Like-Kind Property Issues

Air Rights - Air rights, also known as “Transferable Development Rights,” (TDRs) are defined as unused rights to develop a property to the extent permitted under state or local law.

TDRs are “like-kind” to a fee interest in real property.

In PLR 200805012, the “IRS” noted that “[t]he types of property rights and interests that constitute interests in real property...for purposes of §1031 are broad” and that “[w]hether property constitutes real or personal property generally is determined under state or local law.”

Creative Like-Kind Property Issues

Perpetual Communications Easement (Cell Tower)

If the communication easement is perpetual (e.g., runs with the land), then there is another 1031 exchange structuring opportunity.

The creation of a lease or the grant of a license results in a contract right to receive rent or license fees over time. Rents and license fees are generally included in the taxpayer's income when received.

A perpetual easement can be exchanged for a fee simple interest.

A conservation easement in a farm property can be exchanged for a fee simple interest in other real property.

An agricultural use easements qualifies for tax deferral.

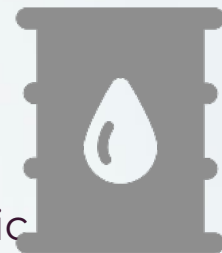
Timber rights for a fee simple interest.



Creative Like-Kind Property Issues

Oil, Gas & Mineral Rights

- Permitted if the mineral rights constitute an interest in real property.
- The determination of whether real property depends on (i) the specific nature of the rights granted under the mineral contract (ii) the duration of those rights and (iii) whether state laws recognize the mineral interests as interests in real property versus personal property.
- A “production payment” is considered personal property because it is a right to receive income rather than an ownership interest in the minerals. Personal property does not qualify under Section 1031.
- A royalty interest is generally considered real property due to the term of the interest. The royalty continues until the gas or oil is exhausted (contrasted with a production payment which terminates when a specified quantity of oil or gas have been produced.)



Fractional Ownership

- What is a typical fractional ownership investment?
- Advantages of fractional ownership
- Risks involved in fractional ownership
- Tenant-In-Common (TIC): Rev. Proc. 2002-22
- Delaware Statutory Trust (DST): Rev. Rul. 2004-86
- For more information, visit: adisa.org (Alternative and Direct Investment Securities Organization)



Fractional Ownership: DST vs TC

DST STRUCTURE

TIC STRUCTURE

IRS Guidance

Rev. Rul. 2004-86

Rev. Proc. 2002-22

Maximum Number of Investors

No IRS imposed limitation

Up to 35

Ownership

Percentage of beneficial
ownership in a DST

Undivided tenant in common interest
in real property

Investors Receive Property Deed

No

Yes

Investors Form Single Member LLC

No

Yes (generally)

Major Decision Approval

No voting rights

Equal voting rights and unanimous approval

Number of Borrowers

1 (the DST)

Up to 35 (max number of investors)

Bankruptcy Remote

Yes

No/Yes (if using a single member LLC)

Fractional ownership: DST

- Only for an “accredited investor” (a high net worth investor as defined in Regulation D of the Securities Act of 1933).
- A Delaware Statutory Trust (DST) is a separate legal entity created as a trust under the laws of Delaware in which each owner has a “beneficial interest” in the DST and is treated as owning an undivided fractional ownership in the property.
- Chief advantage of a DST is the lender views the trust as only one borrower.
- Investors only right to the property is receiving distributions and they have no voting authority regarding the operation of the property.
- “Bad boy carve outs” are eliminated and the lender looks to the sponsor for these carve outs from the non-recourse provisions of the loan.



The Exchange Equation

The Exchange Equation

For full tax deferral, a taxpayer must meet two requirements:

1. Reinvest all net exchange proceeds
2. Acquire property with the same or greater debt.

Relinquished	
Value	\$9,000,000
- Debt	\$3,000,000
- Cost of Sale	\$600,000
Net Equity	\$5,400,000

The Exchange Equation

For full tax deferral, a taxpayer must meet two requirements:

1. Reinvest all net exchange proceeds
2. Acquire property with the same or greater debt.

	Relinquished	Replacement
Value	\$9,000,000	\$12,000,000
- Debt	\$3,000,000	\$6,600,000
- Cost of Sale	\$600,000	
Net Equity	\$5,400,000	\$5,400,000

The Exchange Equation

For full tax deferral, a taxpayer must meet two requirements:

1. Reinvest all net exchange proceeds
2. Acquire property with the same or greater debt.

	Relinquished	Replacement	Boot
Value	\$9,000,000	\$12,000,000	
- Debt	\$3,000,000	\$6,600,000	\$0
- Cost of Sale	\$600,000		
Net Equity	\$5,400,000	\$5,400,000	\$0


The taxpayer acquired property of greater value, reinvesting all net equity and increasing the debt on the replacement property.

Analysis: There is no boot.

The Exchange Equation

For full tax deferral, a taxpayer must meet two requirements:

1. Reinvest all net exchange proceeds
2. Acquire property with the same or greater debt.

	Relinquished	Replacement	Boot
Value	\$9,000,000	\$7,000,000	
- Debt	\$3,000,000	\$2,600,000	\$400,000
- Cost of Sale	\$600,000		
Net Equity	\$5,400,000	\$4,400,000	\$1,000,000
Total Boot			\$1,400,000

The taxpayer acquired property of a lower value, keeps \$1,000,000 of the net equity and acquired a replacement property with \$400,000 less debt.

Analysis: This results in a total of \$1,400,000 in boot.
 (\$400,000 mortgage boot and \$1,000,000 in cash boot = \$1,400,000)

OFFICE - Exchange Equation



	Relinquished	Replacement	Boot
Value	\$5,000,000		
- Debt	\$1,500,000		
- Cost of Sale	\$300,000		
Net Equity	\$3,170,000		

Taxpayer relinquishes an office building that is sold for \$5,000,000 with \$1,500,000 in debt and costs of sale of \$300,000, leaving the taxpayer with \$3,170,000 net equity to reinvest in a 1031 exchange.

OFFICE - Exchange Equation



	Relinquished	Replacement	Boot
Value	\$5,000,000	\$7,000,000	
- Debt	\$1,500,000	\$4,500,000	
- Cost of Sale	\$300,000		
Net Equity	\$3,170,000	\$2,500,000	

The taxpayer purchases one replacement property, another office building worth \$7,000,000 with a \$4,500,000 in debt and reinvests \$2,500,000 in equity.

OFFICE - Exchange Equation

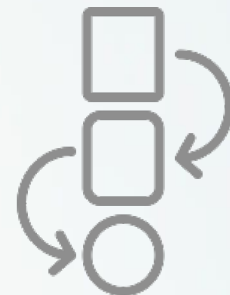


	Relinquished	Replacement	Boot
Value	\$5,000,000	\$7,000,000	
- Debt	\$1,500,000	\$4,500,000	\$0
- Cost of Sale	\$300,000		
Net Equity	\$3,170,000	\$2,500,000	\$670,000

Analysis: Even though the taxpayer acquired a more expensive replacement property, they have \$670,000 in boot because the taxpayer did not reinvest all of the net equity in one or more replacement properties.

Formats & Variations

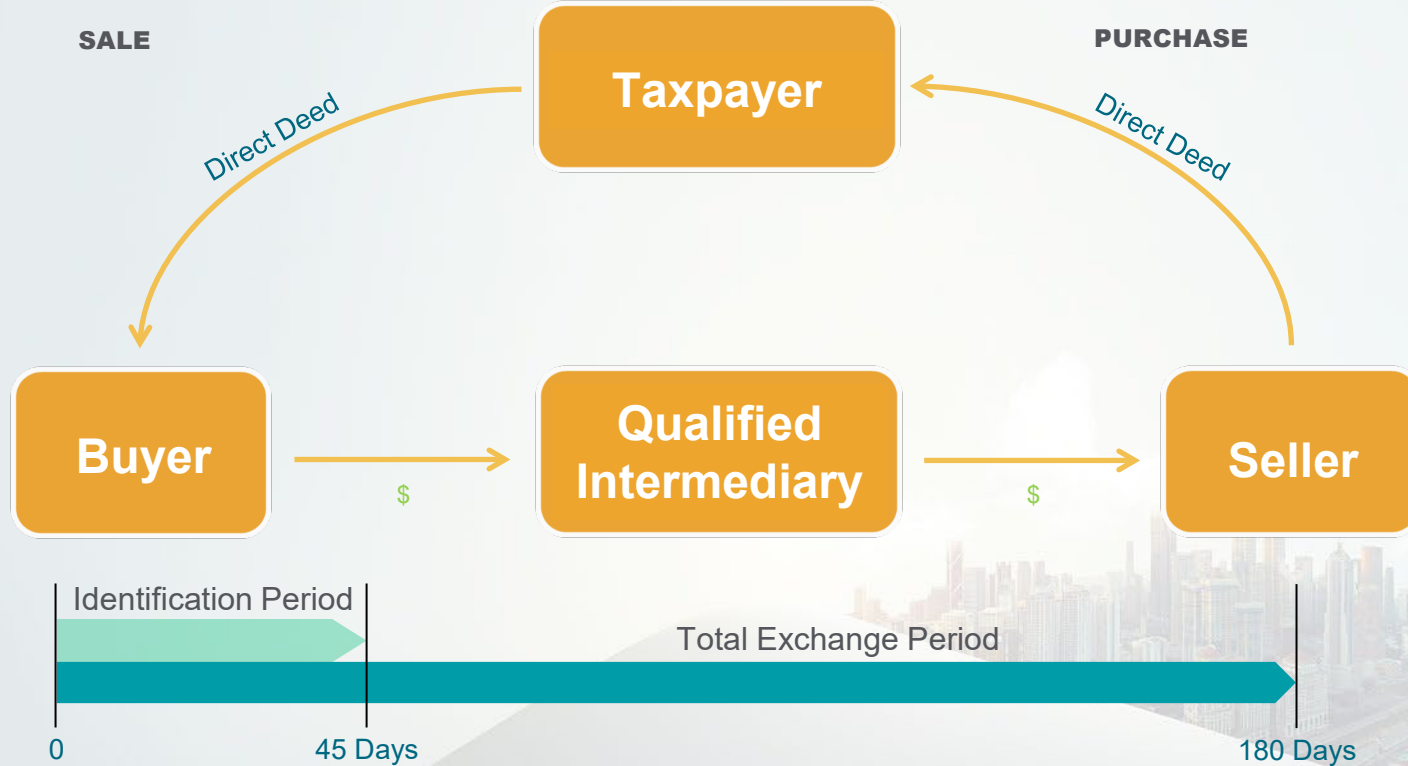
- Two-Party Trade (“Swap”)
- Three-Party Format (“Alderson”)
- Delayed Exchange with a Qualified Intermediary (“QI”)
- Reverse Exchange (“Parking Arrangement”)
- Improvement Exchange (“Parking Arrangement”)
- Reverse/Improvement (“Parking Arrangement”)





The Delayed Exchange

The Delayed Exchange



Time Requirements



45 Day Identification Period:

The taxpayer must identify potential replacement property(s) by midnight of the 45th day from the date of sale.



180 Day Exchange Period:

The taxpayer must acquire the replacement property by midnight of the 180th day, or the date the taxpayer must file its tax return (including extensions) for the year of the transfer of the relinquished property, whichever is earlier.

Identification Rules

3 Property Rule

The taxpayer may identify up to three properties of any fair market value.

200% Rule

The taxpayer may identify an unlimited number of properties provided the total fair market value of all properties identified does not exceed 200% of the fair market value of the relinquished property.

95% Rule

If the taxpayer identifies properties in excess of both of the other rules, then the investor must acquire 95% of the value of all properties identified.

Identification Rules

Identification must be:

- Made in writing
- Unambiguously describe the property
- Hand delivered, mailed, telecopied or otherwise sent
- Sent by midnight of the 45th day
- Delivered to the qualified intermediary or a party related to the exchange who is not a disqualified person



What Not To Do In An Exchange



Christensen v. Commissioner

(Didn't file extension to obtain full 180 days)

Knight v. Commissioner

(Closed after the 180th day)

Dobrich v. Commissioner

(Backdated the Identification Notice)

Parking Arrangements

What is a Reverse Exchange?

Purchasing the replacement property before the sale of the relinquished property.

What is an Improvement Exchange?

Building a new replacement property from the ground-up or making improvements to an existing replacement property.

What is a Reverse/Improvement Exchange?

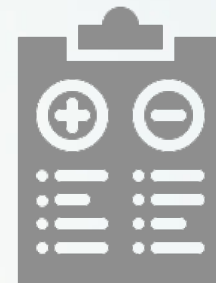
Purchase the replacement first and begin construction before closing on the sale of the relinquished property.

The Reverse Exchange

Parking the Replacement Property

POSITIVES:

- Exchange equity does not need to be present
- Allows for multiple relinquished properties



NEGATIVES:

- Lender may have issues lending to the EAT

The Reverse Exchange

Parking the Relinquished Property

POSITIVES:

- Loan and purchase easier (direct loan to taxpayer)

NEGATIVES:

- Equity and debt should match at the beginning to avoid boot
- Lender issues (due on sale)

The Improvement Exchange

Why Perform an Improvement Exchange?

- The property to be acquired in the exchange is not of equal or greater value to property being sold.
- Build a new investment from ground-up.
- The new investment is of equal or greater value, but it needs refurbishments.





THE IMPROVEMENT EXCHANGE

...if not within the provisions of Section 1031(a) if the relinquished property is transferred in exchange for services (including production services). Thus, any additional production occurring with respect to the replacement property after the property is received by the taxpayer will not be treated as the receipt of property of like-kind.”



THE IMPROVEMENT EXCHANGE

Identification of Replacement Property to be Produced

...if a legal description is provided for the underlying land and as much detail is provided regarding construction of the improvements as is practicable at the time identification is made.”

QI Due Diligence

This is the most important choice a taxpayer will make in a Section 1031 exchange.

Paramount to every 1031 exchange is the safety of funds held by the Qualified Intermediary.



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QI Due Diligence

- Does the Qualified Intermediary offer customers the written backing of a large creditworthy entity?
- What is the financial rating and balance sheet of this entity?
- Does the Qualified Intermediary conduct due diligence on the depositories holding the funds and monitor them?



QI Due Diligence

- Does the Qualified Intermediary offer segregated accounts?
- Does the Qualified Intermediary offer a qualified escrow account?
- Does the Qualified Intermediary offer a qualified trust account?
- Does the Qualified Intermediary have sufficient fidelity bond coverage?

Thank You



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