2025 Title Tenets Webinar Series

Special 1031 Issues For Commercial Property

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Outline

- 1031 Overview
- Exchange Entities
- Partnership and LLC Exchanges
- Partial Exchange
- Seller Financing
- Parking Arrangements
- Reverse Exchanges
- Improvement Exchanges
- Inadvertently Creating Boot

Capital Gain Taxation

20% capital gain tax rate for high earners

3.8% “Net investment income tax” (NIIT) pursuant to IRC Section 1411

Capital gain taxation includes 5 components:

1) Taxation on depreciation recapture at 25% - *plus*
2) Federal capital gain taxes at 20% (or 15%) - *plus*
3) 3.8% tax on net investment income - *plus*
4) The applicable state tax rate (0% - 13.3%)
5) The applicable local tax rate (NYC)

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

Intent to Hold for Investment

- "Intent" is the taxpayer's subjective intent
- The IRS will look at objective factors that either support or negate the taxpayer's intent to hold for investment
- All facts and circumstances taken into account
- The holding period is just one (of many) factors
- Ideally the taxpayer has multiple factors to establish the intent to hold for investment
- Contrary facts may lead the IRS to conclude the property was not held for investment purposes
- Goolsby v. Commissioner (2010)
- Reesink v. Commissioner (2012)

Exchange Entities - General

Generally, the same tax owner should take title to the replacement property in the same manner they held title to the relinquished property. Some examples are below:

- 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.

§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.
- 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

- Both drops and swaps and swaps and drops present separate challenges
- Drop and Swap Challenges Include:
  1. Holding Period
  2. Creation of Legal Tenant In Common Arrangement
  3. Changing Business Conduct to Reflect TICs
  4. Practical Considerations: Promotes, Management Agreement
  5. Possible violation of loan covenants
  6. Whether Sole Asset Owned by Partnership

§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

- Swap and Drop Challenges Include
  1. Identification of Replacement Property
  2. Holding Period Post Acquisition
  3. Distribution in manner which satisfies a pro-rata distribution of partnership assets
  4. Practical considerations: Partners remain together for period
  5. Lender Consent if any

§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).

Partial Exchanges

- Where exchanger intends at the closing of the sale of relinquished property to pocket part of the cash
- The amount excluded paid directly to the exchanger at closing
- Taxable boot subject to offsets
- Must specify before closing or pursuant to G-6 must be held by QI until end of the exchange
- If uncertain whether to include in exchange, include as otherwise will need to apply after tax dollars to purchase

Partial Exchanges

Partial Exchanges: Taxpayer Wants Some Sale Proceeds

- Taxpayer can choose to receive cash proceeds (generally taxable boot)

A. From the Relinquished Property Closing

B. After the 1031 Exchange is Complete (all rep. property acquired)

C. Combination of Relinquished Property Closing and Post – Exchange

- Taxpayer should notify the closer the exact amount of proceeds they want released as taxable boot and the amount going to the Qualified Intermediary for the 1031 exchange
- The QI documents may also need the cash boot amount reflected

Seller Financing in a 1031

If the note made payable to Qualified Intermediary at closing

1. Seller can purchase all or part of note with separate funds prior to purchasing replacement property within the exchange period.
2. Third party can purchase note in same time as noted above.
3. The note may be used as payment for the purchase of replacement property. In this scenario, the note is assigned to the seller by the QI and delivered to the seller at closing.
4. The payer on the note can pay off the note prior to closing on the replacement property. The note is actually paid off during the exchange. This works only on short-term notes due within the 180-day exchange period. The payer pays off the note directly to the Intermediary, the holder of the note.

Parking Arrangements

What is a Reverse Exchange?

- Closing on the replacement property before the sale of the relinquished property. Note: contracting to buy the replacement before the sale of the relinquished property does not constitute a reverse exchange.

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.

Leasehold Improvement Exchange

- Construct improvements on a long-term (30+ years) leasehold interest and transfer the leasehold interest with improvements to the taxpayer.

Rev. Proc. 2000-37

Effective September 15, 2000

- Provides a “safe harbor” for reverse exchange transactions that stay within the parameters of the Revenue Procedure.
- Reverse exchanges may be structured outside the safe harbor.

The Reverse Exchange

Parking the Replacement Property

POSITIVES:

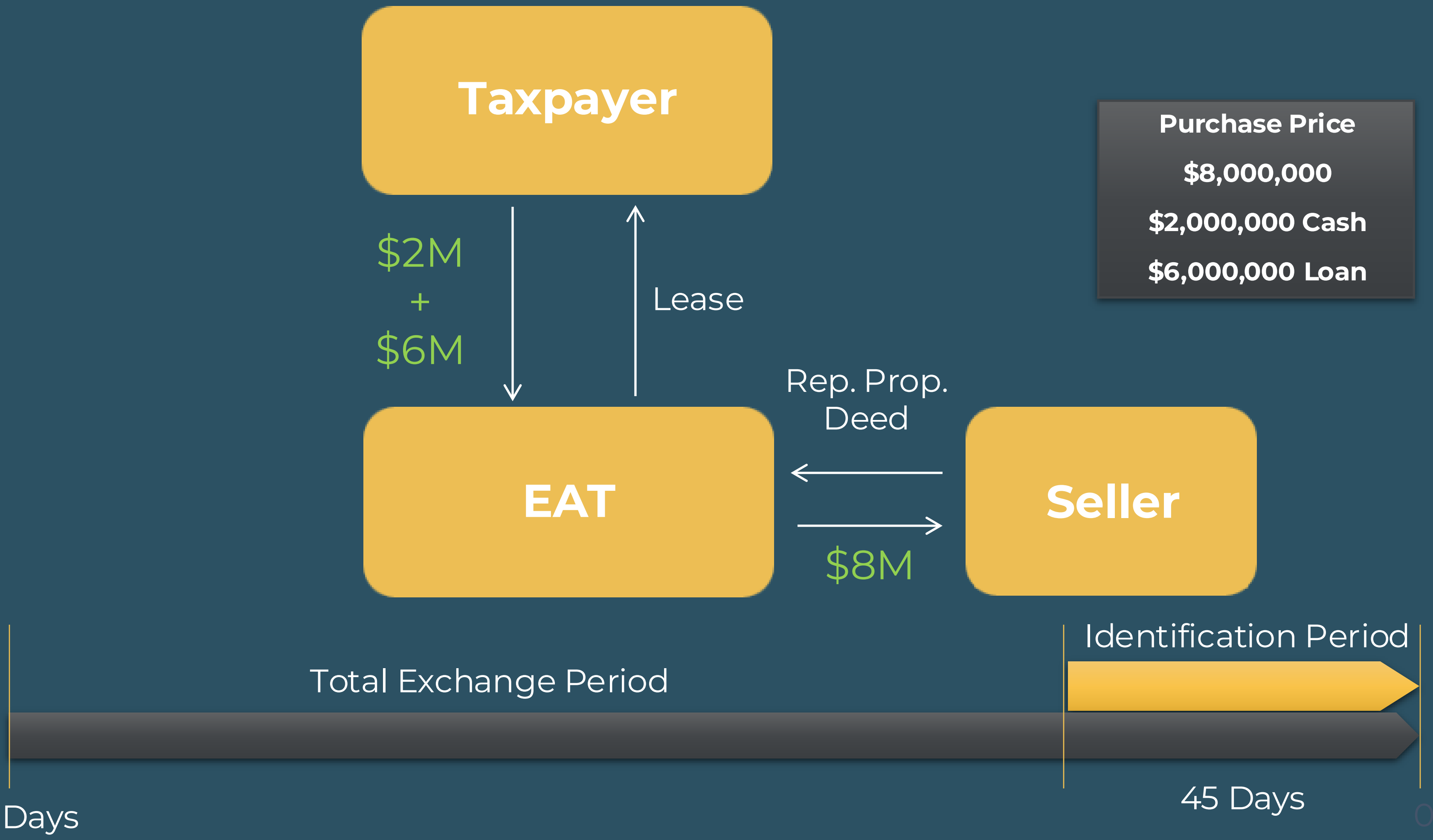
- Exchange equity does not need to be present
- Allows for multiple relinquished properties

NEGATIVES:

- Lender may have issues lending to the Exchange Accommodation Titleholder (EAT)
- Beware Prepayment Penalty
- Non recourse to EAT-guarantee permissible

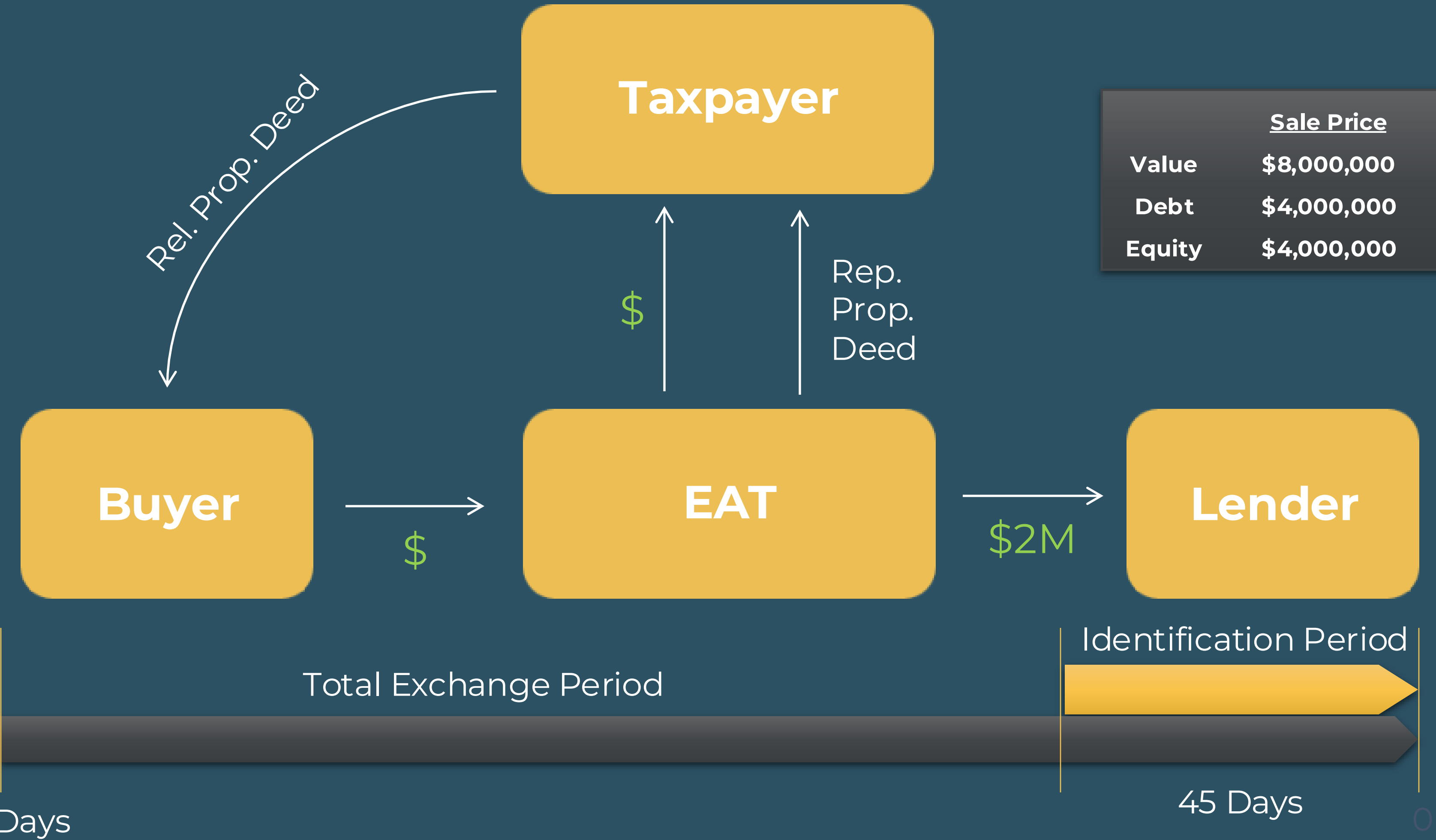
Reverse Exchange Format

Replacement Property Parked - Step 1



Reverse Exchange Format

Replacement Property Parked - Step 2



	Sale Price	Purchase Price
Value	$8,000,000	$8,000,000
Debt	$4,000,000	$6,000,000
Equity	$4,000,000	$2,000,000

Reverse Exchange Format

Replacement Property Parked - Step 3

Prior to transferring title to replacement property to exchanger, $2 million of the sale proceeds must be used to pay down the loan on the replacement property to achieve full deferral.

	Sale Price	Purchase Price
Value	$8,000,000	$8,000,000
Debt	$4,000,000	$6,000,000 Less $2,000,000 paydown= $4,000,000
Equity	$4,000,000	$2,000,000 +$2,000,000 additional equity =$4,000,000

The Reverse Exchange

Parking the Relinquished Property

POSITIVES:

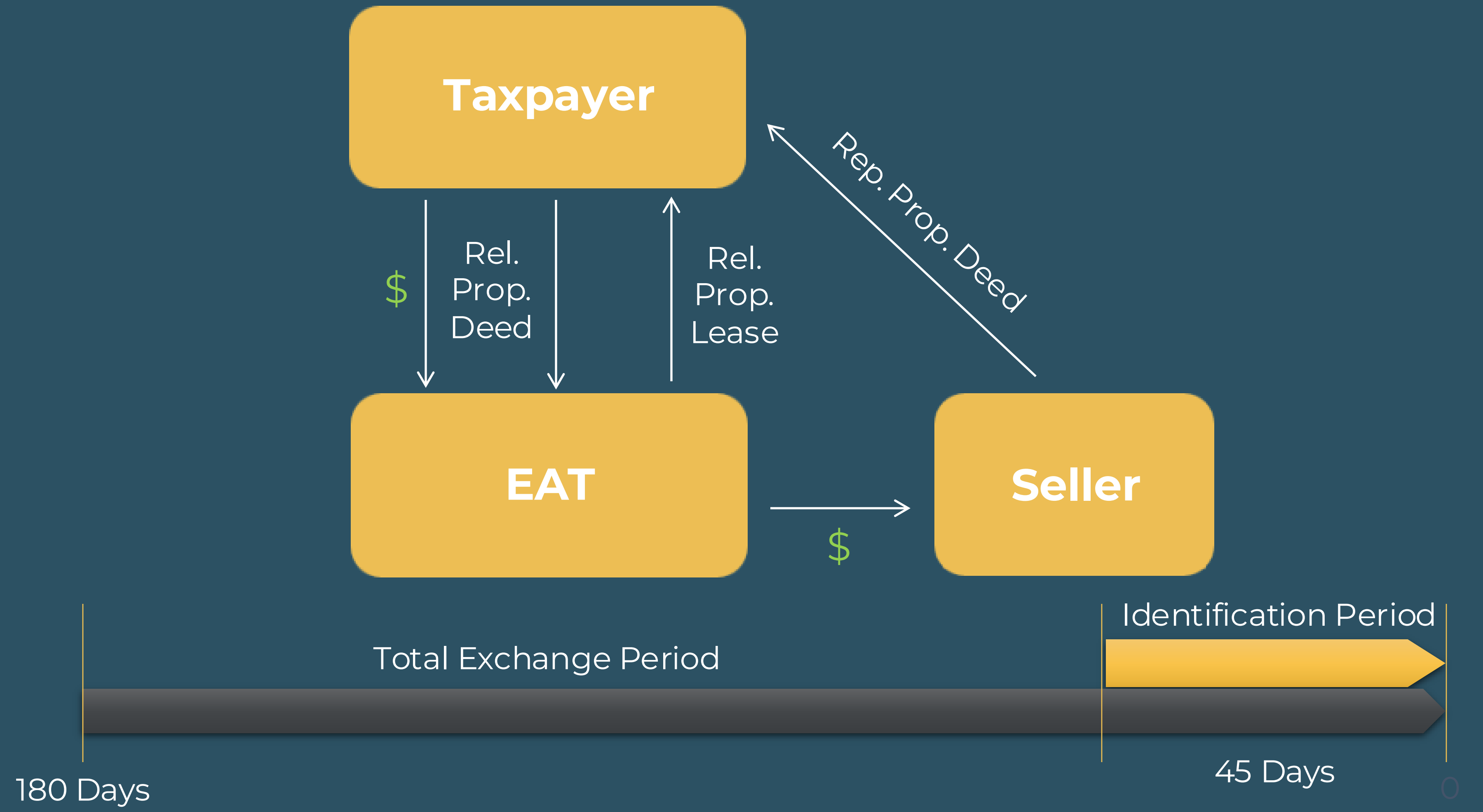
- Loan on replacement property and purchase easier (direct loan to taxpayer). EAT not involved with lender

NEGATIVES:

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

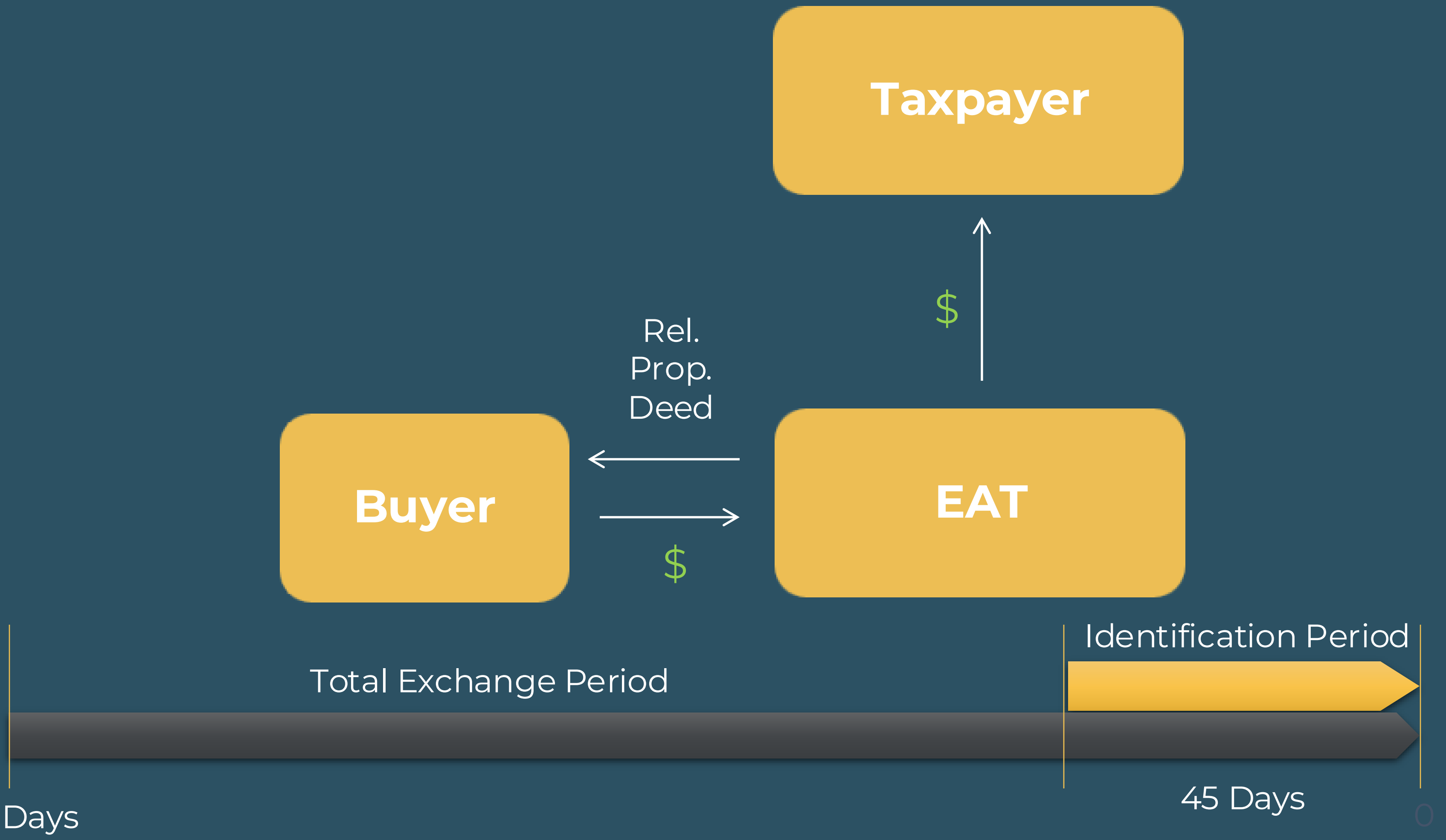
Reverse Exchange Format

Relinquished Property Parked - Step 1



Reverse Exchange Format

Relinquished Property Parked - Step 2



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.

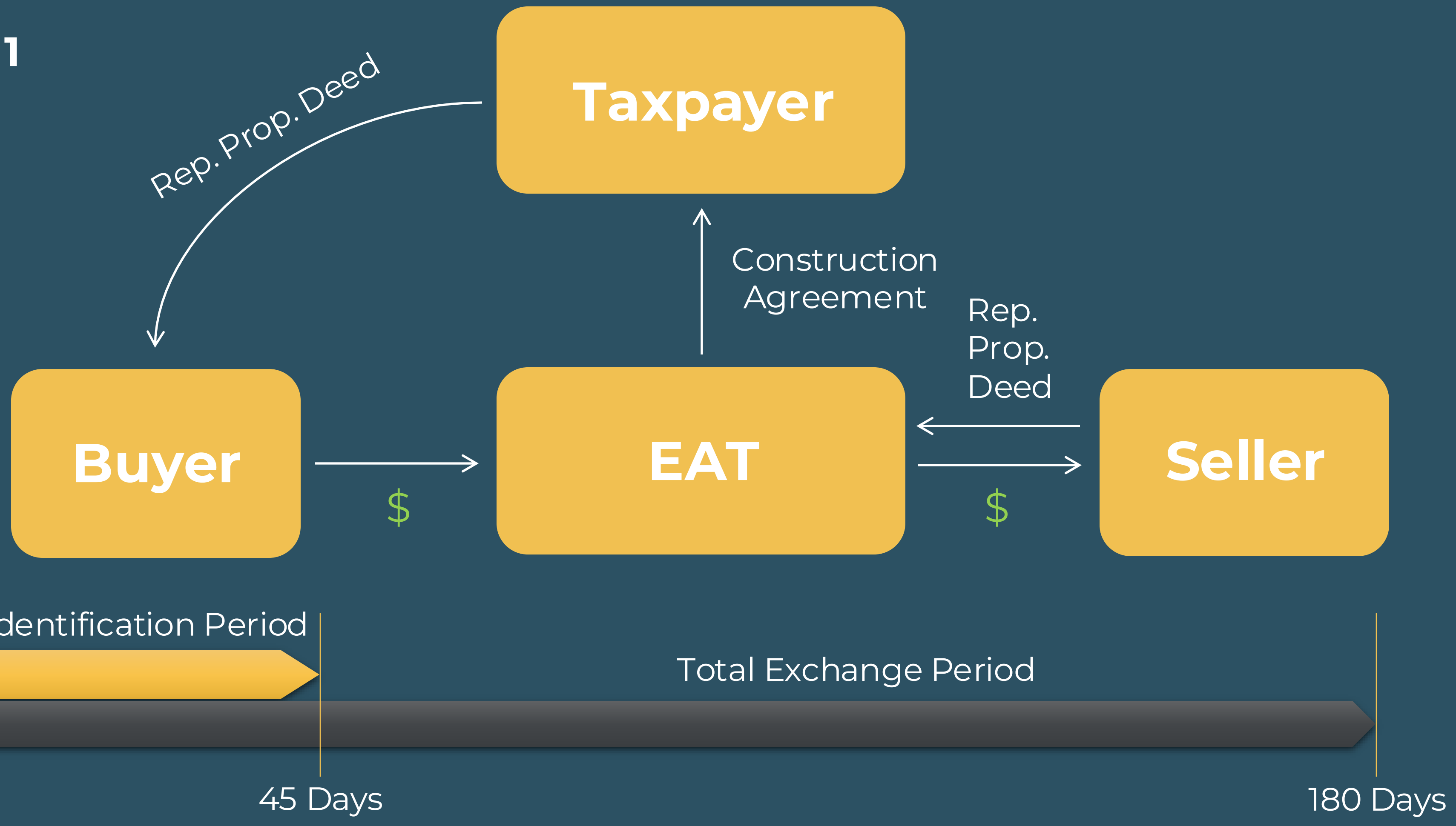
The Improvement Exchange

ID 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."

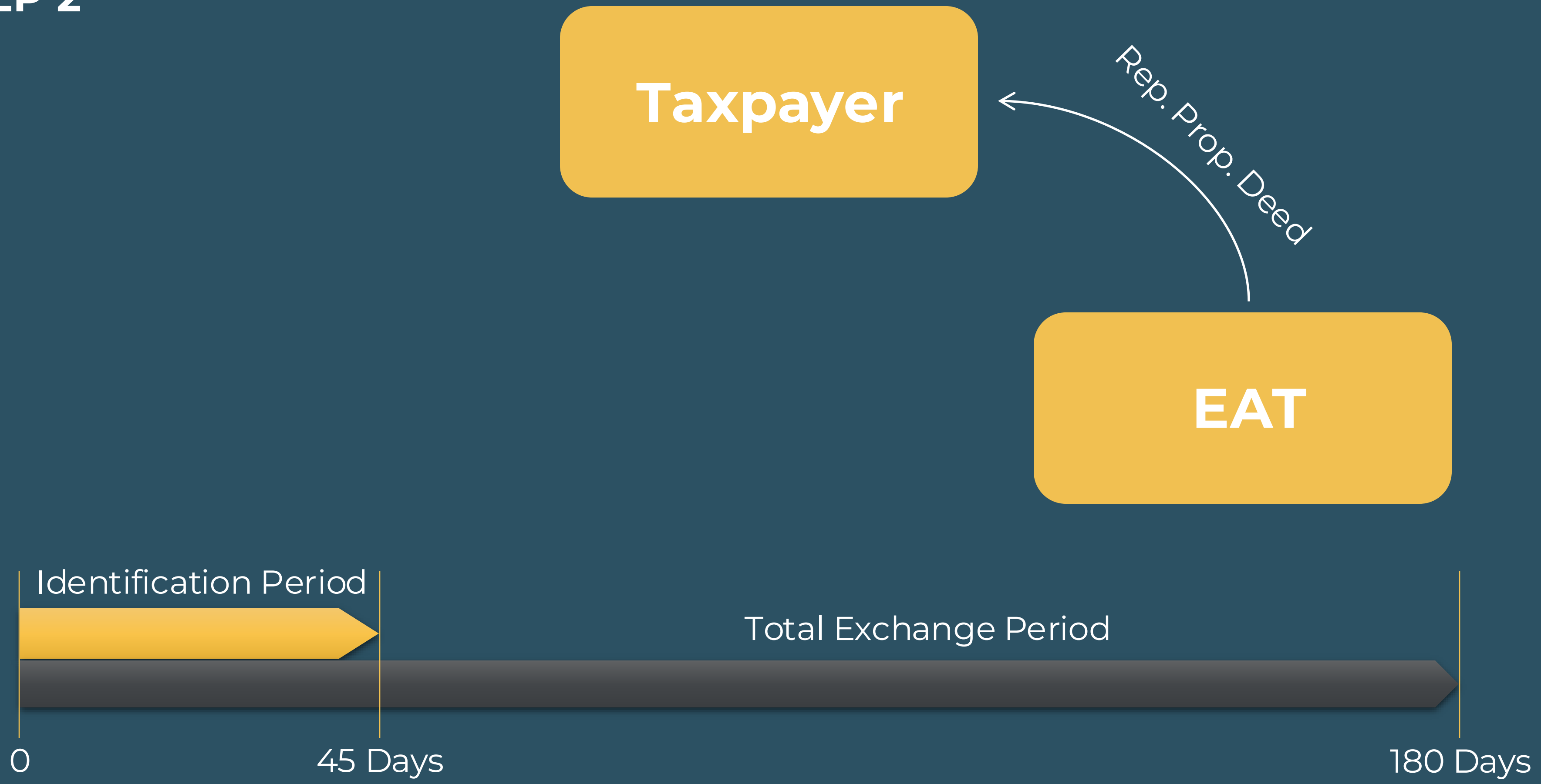
The Improvement Exchange

STEP 1



The Improvement Exchange

STEP 2



The Improvement Exchange

How do the numbers work out?

Relinquished Property	
Sales Price	$5,000,000
Debt	$0
Cost of Sale	$300,000
Net Equity to QI	$4,700,000

Replacement Property	
Lot Purchase (cash)	$3,000,000
Draw 1 site work	$1,200,000
Draw 2 foundation	$500,000
Exchange Value	$4,700,000

Closing Costs

Exchange Expenses:

- Transfer taxes, real estate agent/broker commissions, attorney fees, recording fees, qualified intermediary fees, title insurance fees
- Will not generate boot

Transactional Costs:

- 1.1031(k)-1(g)(7) defines
- Examples: real estate taxes, rents and other pro-rations
- May generate boot

Inadvertent Use of Equity Creating Boot

- Credits to purchase price on the sale of relinquished property
- Repairs, Security Deposits, Operating Loans
- Defeasance fees
- Reserves required by lender for replacement property
- Cannot use for operating expenses and operating loans
- Personal property included in relinquished property sale and proceeds not separately allocated in contract and at closing
- Can only spend proceeds for exchange expenses (EE) and replacement property
- If on reviewing settlement statement proceeds are being used for other than replacement property or EE, likely taxable boot
- Exchange Expenses: transfer taxes, brokers commissions, recording fees, title insurance fees, QI fees and legal fees

Q1 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 (QI).
- Does the QI provide depository options?
- Does the QI provide written backing from a large creditworthy entity?

Q1 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.
Questions?

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