

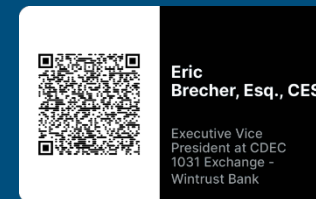


IRC §1031

Tax-Deferred Exchanges and Ethical Considerations


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What you will learn today...

- 
- Why Exchange?
 - Exchange Timelines & Rules
 - Types of Exchanges
 - Ethical Considerations for Lawyers
 - Recent Developments
 - The Role of the Qualified Intermediary



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Common Terminology

Relinquished Property, downleg- property that is sold in a 1031 exchange.

Replacement Property, upleg- property that is acquired in a 1031 exchange.

Qualified Intermediary, QI, facilitator, accommodator - an independent third party that acts to facilitate a Forward Exchange.

Forward Exchange, Tax-deferred Exchange, Starker Exchange, Like-kind Exchange - a transaction where a Taxpayer sells investment property (the Relinquished Property) and later acquires “like-kind” property (the Replacement Property).



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Common Terminology

Identification Period - within 45 days of the transfer of the Relinquished Property, Taxpayer must identify a limited number of potential replacement properties to be acquired to complete the exchange.

Exchange Period - Within 180 days of the transfer of the Relinquished Property, Taxpayer must acquire one or more of the identified replacement properties.

The Code - The Internal Revenue Code, IRC Section 1031

The Regs. - Treasury Regulations issued in 1991 that created the safe harbors for structuring a Section 1031 exchange.

The Service - The Internal Revenue Service

Taxpayer - An owner of business or investment property who intends to exchange that property in a tax-deferred transaction.



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IRC Section 1031



Section 1031 has been part of the Internal Revenue Code since 1921.



The language of the Code has been modified very little since 1921, but significant regulatory guidance has made these transactions accessible to all taxpayers.



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Starker and The 1984 Tax Reform Act

- In the mid-1970s, the **Starker** cases set the stage for the non-simultaneous exchange.
- In 1984, the Tax Reform Act formally sanctioned the delay between the disposition of relinquished property and the acquisition of replacement property.
- The 1984 Tax Reform Act also imposed the **45-day Identification Period** and the **180-day Exchange Period**.



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1991 Treasury Regulations: Delayed Exchange Safe Harbors



Effective June 10, 1991 Created “Safe Harbors”

Exchanges structured in a manner which is not sanctioned by the safe harbors will not automatically be non-qualifying, but will be carefully scrutinized.



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1031 Exchange – Internal Revenue Code

- 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 for productive use in a trade or business or for investment.

OR in Layman's Terms:

- A Section 1031 Exchange allows an owner of investment real property to exchange real property **defer paying federal capital gains tax, depreciation recapture tax and state income taxes** and if they purchase “like-kind” real property following rules and regulations of the IRC.



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What does Section 1031 say? Effective January 1, 2018:

- IRC Section 1031(a)(2): Exception for real property held for sale.
- This subsection does not apply to any exchange of real property **held primarily for sale.**

DELETED PROVISIONS:

- (A) stock in trade or other property held primarily for sale,
- (B) stocks, bonds, or notes,
- (C) other securities or evidences of indebtedness or interest,
- (D) interests in a partnership,
- (E) certificates of trust or beneficial interests, or
- (F) choses in action.




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Competence



Rule RPC 1:1 - Competence

A lawyer shall not:

- 
- (a) Handle or neglect a matter entrusted to the lawyer in such manner that the lawyer's conduct constitutes gross negligence

 - (b) Exhibit a pattern of negligence or neglect in the lawyer's handling of legal matters generally



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Fields of Practice

- **RULE RPC 7:4 - Communication of Fields of Practice and Certification**

- (a) A lawyer may communicate the fact that the lawyer does or does not practice in particular fields of law. A lawyer may not, however, state or imply that the lawyer has been recognized or certified as a specialist in a particular field of law except as provided in paragraphs (b), (c), and (d) of this Rule.
- (b) A lawyer admitted to engage in patent practice before the United States Patent and Trademark Office may use the designation "Patent Attorney" or a substantially similar designation.



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Fields of Practice



RULE RPC 7:4 - Communication of Fields of Practice and Certification

(c) A lawyer engaged in admiralty practice may use the designation "Admiralty," "Proctor in Admiralty," or a substantially similar designation.



(d) A lawyer may communicate that the lawyer has been certified as a specialist or certified in a field of practice only when the communication is not false or misleading, states the name of the certifying organization, and states that the certification has been granted by the Supreme Court of New Jersey or by an organization that has been approved by the American Bar Association. If the certification has been granted by an organization that has not been approved, or has been denied approval, by the Supreme Court of New Jersey or the American Bar Association, the absence or denial of such approval shall be clearly identified in each such communication by the lawyer.



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Scope of rep

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- 
- **RULE RPC 1:2 - Scope of Representation and Allocation of Authority Between Client and Lawyer**
 - (a) A lawyer shall abide by a client's decisions concerning the scope and objectives of representation, subject to paragraphs (c) and (d), and as required by RPC 1.4 shall consult with the client about the means to pursue them. A lawyer may take such action on behalf of the client as is impliedly authorized to carry out the representation. A lawyer shall abide by a client's decision whether to settle a matter. In a criminal case, the lawyer shall consult with the client and, following consultation, shall abide by the client's decision on the plea to be entered, jury trial, and whether the client will testify.
 - (b) A lawyer's representation of a client, including representation by appointment, does not constitute an endorsement of the client's political, economic, social or moral views or activities.



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Ethical Issues for IRC Section 1031 Advisors

Limit the scope of your engagement

Scope Broadly Defined:

“We have been engaged to represent you in the disposition of the real property located at _____”

Limit Defined Services:

“We have been engaged to represent you in the negotiation of terms, drafting of documents, and closing of the disposition of real property.”

Express Exclusion of Services:

The scope of our engagement **does not include** advice or services regarding accounting or tax.



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Communication



- **RULE RPC 1:4 - Communication**

- (a) A lawyer shall fully inform a prospective client of how, when, and where the client may communicate with the lawyer.

- (b) **A lawyer shall keep a client reasonably informed about the status of a matter and promptly comply with reasonable requests for information.**

- 
- (c) A lawyer shall explain a matter to the extent reasonably necessary to permit the client to make informed decisions regarding the representation.

- (d) **When a lawyer knows that a client expects assistance not permitted by the Rules of Professional Conduct or other law, the lawyer shall advise the client of the relevant limitations on the lawyer's conduct.**



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Why Exchange?



Tax Deferral

- 20% Federal Capital Gain Tax for assets held > 1 year
- 25% Federal Depreciation Recapture Tax
- State Income Taxes (if applicable)
- 3.8% Medicare Tax on net investment income



Other Advantages of Exchanging

- Diversification
- Consolidation
- Greater cash flow
- Estate planning





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IRC Section 1031

Three General Statutory Requirements

- 
- Properties must be held for **Business or Investment Use**
 - Properties must be **Like-Kind** to each other
 - The transaction must be structured as an **Exchange** of one property for another, as distinguished from a sale followed by an acquisition.
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Held for Investment Requirement

- 
- For purposes of section 1031, neither the Code nor the regulations define “held for investment.”
 - The regulations provide that “[u]nproductive real estate held by one **other than a dealer** for future use or future realization of the increment in value is held for investment and not primarily for sale”. Sec. 1.1031(a)-1(b), Income Tax Regs.
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Held for Investment Requirement

Property Held for Sale – Dealer Property

IRC Section 1221(a)(1) defines a capital asset as excluding any property held by a Taxpayer for sale to customers in the ordinary course of his trade or business.

Gain or loss on property held for sale by a dealer is generally treated as ordinary income for tax purposes.




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Held for Investment Requirement



Property must be held for **investment** or **for use in a trade or business** in which Taxpayer is engaged.

How long must the Taxpayer own the property prior to the exchange?

- 
- Intent is key to this inquiry.
 - Look at facts and circumstances.
 - Consider individual risk tolerance.
 - Consider Taxpayer's behavior.



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Held for Investment Requirement

- In **Bolker v. Commissioner**, 760 F.2d 1039, 1045 [56 AFTR 2d 85-5121] (9th Cir. 1985), affg. 81 T.C. 782 (1983), the court stated that:

“a taxpayer may satisfy the “holding” requirement by owning the property, and the “for productive use in trade or business or for investment” **requirement by lack of intent either to liquidate the investment or to use it for personal pursuits.**”



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Ethical Issues for IRC Section 1031 Advisors

Determining Whether Property is Qualifying Property

Taxpayer sells investment property in August and acquires replacement property in November.

In January, Taxpayer enters into a contract to sell the newly acquired replacement property and does another like-kind exchange.

Did the Taxpayer hold that replacement property for investment?

What were the circumstances surrounding the Taxpayer's sudden disposition of that replacement property?



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Ethical Issues for IRC Section 1031 Advisors

Determining Whether Property is Qualifying Property

Client acquires a condominium for personal use in May 2020 for \$1.5 million.

Client has an offer from a potential purchaser to acquire the condominium for \$3 million and wants to do a 1031 exchange.

What is your ethical obligation to your client?

Should you tell your client that if the condominium is listed for sale it will qualify?

If the buyer insists on taking possession immediately, should your client enter into a lease with an option to purchase the condominium after two months?



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Held for Investment Requirement

PLR 8429039 – **two years** of business or investment use is sufficient to meet the requirement under IRC Section 1031 that the property was held for the requisite intent.

Neal T. Baker Enterprises, Inc. v. Commissioner (1998) – Taxpayer attempts to exchange vacant land after owning it for **11 years**. Taxpayer is deemed to have held the land “for sale” during the entire holding period.



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Held for Investment Requirement



Adams v. Commissioner – T.C. Memo 2013-7

Taxpayer exchanged a rental property for a single family home in Eureka, California which he rented to his son.



The son made the home livable (after dealing with mold, squatters and bears) and maintained the home while he and his family resided there. The son paid rent that was a **couple hundred dollars below the going rental rate.**



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Held for Investment Requirement

Adams v. Commissioner – T.C. Memo 2013-7

The IRS disallowed the exchange on the ground that **Adams acquired the Eureka, CA property for personal purposes** – specifically to allow his son to live in the home at below-market rent.

The Tax Court held differently – that the Eureka, CA property **was in fact held for investment and that the rent paid by Taxpayer’s son was appropriate** given the level of rehabilitation and upkeep the son provided to the property without charge.




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Held for Investment Requirement

Patrick A. Reesink v. Commissioner, T.C. Memo 2012-18



Taxpayer and his brother owned an apartment complex in San Francisco. After many years of turmoil, Taxpayer filed for partition of the property.

The partition suit was settled and the property was sold. Taxpayer exchanged his tenancy in common interest in the San Francisco Property for a single family rental home.



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Held for Investment Requirement

Patrick A. Reesink v. Commissioner, T.C. Memo 2012-18

Eight months after acquiring the replacement property, Taxpayer sold his primary residence and moved into the recently acquired replacement property.

The IRS disallowed the exchange on the grounds that the property was **not held for investment**.

The Tax Court disagreed and concluded that Taxpayer's actions evidenced his intention to hold the property for investment notwithstanding the fact that the property was never rented.



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Held for Investment Requirement

Goolsby v. Commissioner, T.C. Memo 2010-64

Taxpayer entered into a contract to acquire a single family home in Georgia. The acquisition was conditioned on the sale of Taxpayer's primary residence.

Taxpayer later signed a contract to sell investment property in California. When the investment property sold, Taxpayer entered into a tax-deferred exchange.

Shortly after the sale of the investment property, Taxpayer sold his primary residence and moved in with his in-laws.

To complete his exchange, Taxpayer acquired:

1. the Georgia property; and
2. a four-unit residential property.



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Held for Investment Requirement



Goolsby v. Commissioner, T.C. Memo 2010-64

Taxpayer attempted to rent out the GA property by posting an ad in the local neighborhood circular. At no time did Taxpayer check the homeowners association manual to see if the home could be rented.



After **two months** with no renter, Taxpayer and his wife moved into the GA property.



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Held for Investment Requirement

Goolsby v. Commissioner, T.C. Memo 2010-64

The Tax Court held the GA property was not held for investment based on the following factors:

1. Taxpayer moved into the property two months after acquiring the property.
2. Taxpayer's purchase of the GA property was contingent on Taxpayer's sale of his primary residence.
3. Taxpayer failed to investigate rental opportunities in the area where the property was located and Taxpayer's attempts to rent the property were minimal.
4. Taxpayer's interactions with their Qualified Intermediary showed that Taxpayer was considering moving into the property if renters could not be found.



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Held for Investment



- **La Paloma Nevada OTA Case**

- 
- Taxpayer obtained owner occupied principal residence loan
 - House never rented
 - Appeared to be used as a vacation home
 - Taxpayer argued only used house for maintenance/improvements
 - No records & court didn't believe Taxpayer
 - Accuracy penalties



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Personal Use Property

Revenue Procedure 2008-16

Effective for exchanges occurring after March 9, 2008, this Rev. Proc. provides a safe harbor for Taxpayers who sell “dwelling units” that are held for the production of income and used for personal purposes.



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Personal Use Property

Revenue Procedure 2008-16

1. The dwelling unit is real property that is improved with an apartment, condominium or other living space that includes a sleeping area, kitchen and bathroom.
2. The dwelling unit is owned by the Taxpayer for **at least 24 months** prior to the exchange.
3. In each of the two 12-month periods prior to the exchange, the dwelling unit is **used for personal purposes does not exceed 14 days or 10% of the number of days the dwelling unit is rented.**
4. In each of the two 12-month periods prior to the exchange, the **dwelling unit is rented at a fair rental value for 14 days or more.**





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Like-Kind Standard

- 
- Property classified as realty under state law is “like-kind”.
 - “Like-Kind” refers to the nature or the character of the property, not its grade or quality.
 - Unimproved property is like-kind to improved property.
 - The property need not be income producing.
- 



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Ethical Issues for IRC Section 1031 Advisors

Determining Qualifying Property

Your client is selling a condominium and wants to do a 1031 exchange. How do you determine if the condominium is qualifying property?

What if this is the **10th condominium** in the building that your client has sold?

What if after selling this condo, your client **still owns 15 units** in the same building?

Should you tell your client the sale will not qualify as property held for investment?

Are the units **held primarily for sale**?



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Qualifying Property

Properties that **DO** Qualify

Real property held for investment, income, or a trade or business, and not primarily for sale.

- Rentals homes/condos/**coops**
- Raw land
- Retail
- Industrial/Warehouse
- Office
- Agricultural
- 30 Year Leases
- Easements/**development rights**
- **Options**
- NNN & DSTs
- **License/permit for use/enjoyment or occupation of land**

Properties that **DO NOT** Qualify

Stock in trade or other real property held primarily for sale.

- **Stocks, bonds, notes**
- **Other securities or evidences of indebtedness or interest**
- **Certificates of trust or beneficial interests**
- **Choses in action**
- Partnership Interests
- Primary Residence
- Personal Property (artwork etc.)

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Treasury Issues Final Like-Kind Exchange Regulations – effective 12/2/2020

- 3 alternative tests to determine real property under 1031
 - State Law Test
 - Defined as real property under state or local law in which the property is located
 - Listed Assets Test
 - Land
 - Improvements to land: inherently permanent or structural component
 - Factors Test
 - Manner in which structure is affixed
 - Designed to be removed or remain in place
 - Damage that would be caused to structure or real estate if removed
 - Circumstances suggesting affixation is not indefinite
 - Time and expense required to remove structure



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Treasury Issues Final Like-Kind Exchange Regulations – effective 12/2/2020

- Using QI funds for Personal Property
 - Personal property is incidental to real property acquired in an exchange if, in standard commercial transactions, the personal property is typically transferred together with the real property, and the aggregate fair market value of the incidental personal property transferred with the real property **does not exceed 15 percent** of the aggregate fair market value of the replacement real property
 - Incidental personal property is still not real property and taxable boot if paid for with exchange proceeds



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Ethical Issues for IRC Section 1031 Advisors

Dealing with a Drop & Swap

Brother and Sister own property together in Family LLC, which is taxed as a partnership.

Brother would like to exchange his interest for other investment property.

Sister would like to sell for cash.

Brother and Sister meet with you to discuss a possible drop & swap.

Who should you represent in this situation?

Both brother and sister individually? Only one of the siblings? The partnership?



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Conflict of Interest

- **RULE RPC 1:7 - Conflict of Interest: General Rule**
- (a) Except as provided in paragraph (b), a lawyer shall not represent a client if the representation involves a concurrent conflict of interest. A concurrent conflict of interest exists if:
 - (1) the representation of one client will be directly adverse to another client; or
 - (2) there is a significant risk that the representation of one or more clients will be materially limited by the lawyer's responsibilities to another client, a former client, or a third person or by a personal interest of the lawyer.

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Conflict of Interest

- (b) Notwithstanding the existence of a concurrent conflict of interest under paragraph (a), a lawyer may represent a client if:
- (1) **each affected client gives informed consent, confirmed in writing**, after full disclosure and consultation, provided, however, that a public entity cannot consent to any such representation. When the lawyer represents multiple clients in a single matter, the consultation shall include an explanation of the common representation and the advantages and risks involved;
- (2) the **lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client**;
- (3) the representation is not prohibited by law; and (4) the representation does not involve the assertion of a claim by one client against another client represented by the lawyer in the same litigation or other proceeding before a tribunal.

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Ethical Issues for IRC Section 1031 Advisors

Changing Taxpaying Entity Shortly After Acquisition

A client calls to inform you that she wishes to contribute recently acquired replacement property to **a new LLC partnership** with a developer in order to begin construction on the property.

The client heard that she must hold on to the property for **two years** before changing the tax owner.

What should you advise your client?

What are your ethical obligations in this scenario?



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Ethical Issues for IRC Section 1031 Advisors

Changing Taxpaying Entity Shortly After Acquisition

Should you advise your client to wait two years before contributing the property to the LLC partnership?

Would such advice result in the client losing the development opportunity?

Should you advise your client to form a co-tenancy with the developer?

What are the tax implications of transferring (selling) a co-tenancy interest to the developer?

Should you advise your client to proceed with the contribution to the partnership and development project?

Is there a two-year holding period?



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IRS Form 1065

Please fill out the following form. You can save data typed into this form. Highlight Existing Fields

Form 1065 (2014) Page 3

Schedule B Other Information (continued)

	Yes	No
11 At any time during the tax year, did the partnership receive a distribution from, or was it the grantor of, or transferor to, a foreign trust? If "Yes," the partnership may have to file Form 3520, Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts. See instructions	<input type="checkbox"/>	<input type="checkbox"/>
12a Is the partnership making, or had it previously made (and not revoked), a section 754 election? See instructions for details regarding a section 754 election.	<input type="checkbox"/>	<input type="checkbox"/>
b Did the partnership make for this tax year an optional basis adjustment under section 743(b) or 734(b)? If "Yes," attach a statement showing the computation and allocation of the basis adjustment. See instructions	<input type="checkbox"/>	<input type="checkbox"/>
c Is the partnership required to adjust the basis of partnership assets under section 743(b) or 734(b) because of a substantial built-in loss (as defined under section 743(d)) or substantial basis reduction (as defined under section 734(d))? If "Yes," attach a statement showing the computation and allocation of the basis adjustment. See instructions	<input type="checkbox"/>	<input type="checkbox"/>
13 Check this box if, during the current or prior tax year, the partnership distributed any property received in a like-kind exchange or contributed such property to another entity (other than disregarded entities wholly owned by the partnership throughout the tax year) <input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
14 At any time during the tax year, did the partnership distribute to any partner a tenancy-in-common or other undivided interest in partnership property?	<input type="checkbox"/>	<input type="checkbox"/>
15 If the partnership is required to file Form 8858, Information Return of U.S. Persons With Respect To Foreign Disregarded Entities, enter the number of Forms 8858 attached. See instructions ▶ <input type="text"/>	<input type="checkbox"/>	<input type="checkbox"/>
16 Does the partnership have any foreign partners? If "Yes," enter the number of Forms 8805, Foreign Partner's Information Statement of Section 1446 Withholding Tax, filed for this partnership. ▶ <input type="text"/>	<input type="checkbox"/>	<input type="checkbox"/>
17 Enter the number of Forms 8865, Return of U.S. Persons With Respect to Certain Foreign Partnerships, attached to this return. ▶ <input type="text"/>	<input type="checkbox"/>	<input type="checkbox"/>
18a Did you make any payments in 2014 that would require you to file Form(s) 1099? See instructions	<input type="checkbox"/>	<input type="checkbox"/>
b If "Yes," did you or will you file required Form(s) 1099?	<input type="checkbox"/>	<input type="checkbox"/>

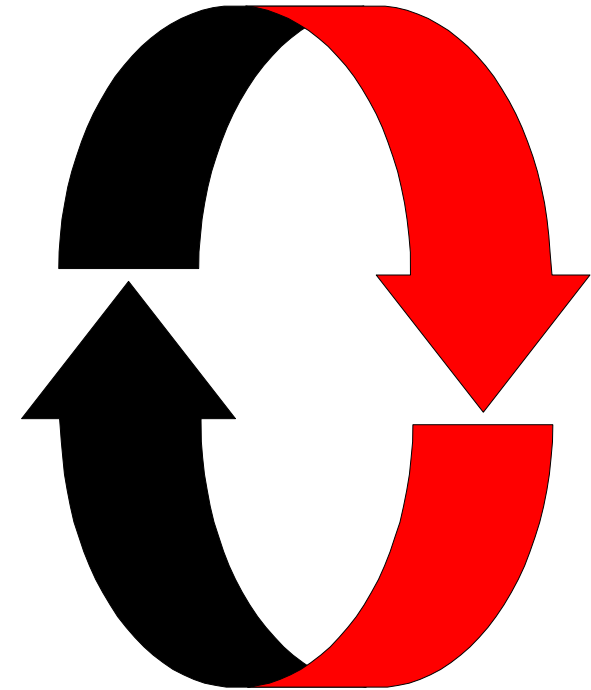


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The Exchange Requirement

- The Exchange must be structured as a reciprocal transfer of one property for another as distinguished from a sale followed by a re-investment.
- Taxpayer may not **actually or constructively** receive the proceeds of sale.



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Maximizing Your Gain Deferral

Napkin Rule

- All cash proceeds from the sale of the Relinquished Property must be reinvested in the Replacement Property (or pay tax on the difference);
- All debt paid off at Closing from the sale of the Relinquished Property must be replaced (or pay tax on the difference) – new equity can offset debt;
- The purchase price of the Replacement Property must be at least as much as the sales price of the Relinquished Property (or pay tax on the difference);
- The purchaser of the Replacement Property must be the same as the seller of the Relinquished Property, or be a “Disregarded Entity”;
- For safe harbor protection, exchange funds should be held by a Qualified Intermediary.



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Calculating Gain & Estimated Tax

Facts:

\$1,000,000	Relinquished Property original purchase price
(\$ 100,000)	- Depreciation deductions taken
\$ 50,000	+ Capital improvements made
\$2,000,000	Relinquished Property sales price

Relinquished Property Adjusted Cost Basis:

\$1,000,000	Relinquished Property original purchase price
(\$ 100,000)	- Depreciation deductions taken
<u>\$ 50,000</u>	+ Capital improvements made
\$ 950,000	Adjusted Cost Basis



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Calculating Gain & Estimated Tax

Gain on Disposition of Relinquished Property:

\$2,000,000 Relinquished Property Sale Price

(\$950,000) Adjusted Cost Basis

\$1,050,000 Realized Gain

Taxes Due Absent a Like-Kind Exchange:

\$ 25,000 Depreciation recapture tax of 25% X \$100,000

\$190,000 Federal capital gains tax of 20% X \$950,000

\$ 52,500 State income tax, assuming 5% average rate X \$1,050,000

\$ 30,400 Net investment income tax of 3.8% X MAGI in excess of \$250,000

\$297,900 Estimated taxes due



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Avoiding BOOT

Relinquished Property

FMV: \$1,500,000

Debt: \$ 500,000

Equity: \$1,000,000

Replacement Property

FMV: \$1,500,000

Debt: \$ 500,000

Equity: \$1,000,000

Taxpayer has re-invested all of its equity AND acquired replacement property of equal or greater value.

No recognized gain.

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Avoiding BOOT



Relinquished Property

FMV: \$1,500,000

Debt: \$ 500,000

Equity: \$1,000,000



Replacement Property

FMV: \$1,500,000

Debt: \$ 750,000

Equity: \$ 750,000



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\$250,000 of equity is not spent on replacement property. Taxpayer recognizes gain on the cash received.

Avoiding BOOT

Relinquished Property

FMV: \$ 1,500,000

Debt: \$ 500,000

Equity: \$1,000,000

Replacement Property

FMV: \$1,250,000

Debt: \$ 0

Equity+ : \$1,250,000

Taxpayer trades down in value by \$250,000 and recognizes gain on the net debt relief of \$250,000

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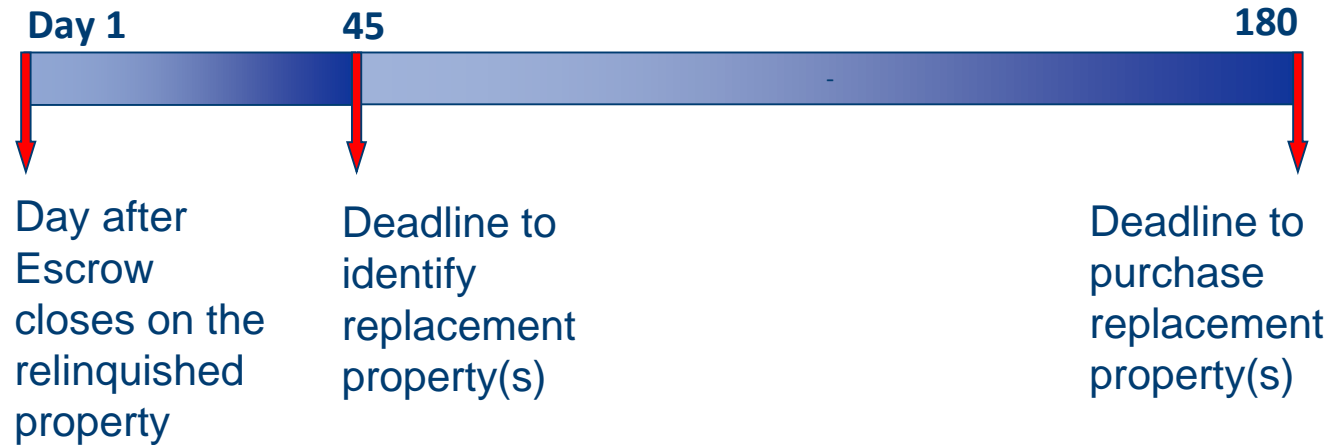
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IRC Section 1031 Exchange Time Periods

The 1031 Exchange time frame begins the day after escrow closes on the relinquished property.

From this point, the **180 day** count down begins.



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Diligence



RULE RPC 1:3 - Diligence

A lawyer shall act with reasonable diligence and promptness in representing a client.



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Extensions to the 1031 Deadlines

- **IRC 7508A** and regulations - lists **time sensitive acts** for federally declared disaster, terroristic or military action
- **IRC 165(h)(3)(c)** – defines “**federally declared disaster**” – “any disaster subsequently determined by the President of the United States to warrant assistance by the Federal Government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act”
- **Rev. Proc. 2018-58** supplements list and **includes 1031 Exchange deadlines** – IRS must publish a notice or issue other guidance
 - **Section 17 provides postponement provisions that apply solely to 1031 Exchanges**
- IRS guidance will define “**affected taxpayers,**” describe acts of postponement, duration of postponement and the location of the covered disaster area

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Extensions to the 1031 Deadlines

Taxpayer qualifies under the general rule if:

1. RQ property transferred on or before the date of the federally declared disaster, or in a Reverse exchange, qualified indicia of ownership transferred to EAT on or before that date and;

2. Taxpayer is an “**Affected taxpayer**” as defined in IRS guidance announcing tax relief for victims of the specific declared disaster OR has difficulty meeting the 45-day ID or 180 day deadlines for the following reasons:

- RQ property or RP property is located in **covered disaster area**;
- Principal place of business of any party to the transaction (QI, EAT, transferee, settlement agent, lender, financial institution or title insurance company) is located in the covered disaster area;



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Extensions to the 1031 Deadlines

2. Taxpayer is an “**Affected taxpayer**” as defined in IRS guidance announcing tax relief for victims of the specific declared disaster OR has difficulty meeting the 45-day ID or 180 day deadlines for the following reasons:

- Any party to the transaction (or an employee of such a party is involved in the 1031 is killed, injured, or missing as a result of the disaster;
- Document in connection with exchange (Exchange Agreement or deed) or land record destroyed, damaged or lost as a result of disaster;
- Lender decides not to fund due to the disaster or refuses to fund or hazard insurance not available due to the disaster; or
- Title insurance company not able to provide title insurance⁵⁷ due to disaster



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See - <https://www.irs.gov/newsroom/tax-relief-in-disaster-situations>

What to consider before entering into a 1031 exchange...

Research how title is vested.

Know how long you've owned your property.

Understand what the tax consequences are of a sale v. an exchange – both on a federal tax basis and a state tax basis.

Know when to open your 1031 Exchange Account.

Research who your QI is and understand what they do with your sale proceeds.

Know that the exchange industry is mostly unregulated.

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Forward Exchange Mechanics



Prior to Closing on the Sale of Relinquished Property:

Taxpayer executes a series of documents evidencing their intent to exchange the property.



At closing, net sale proceeds are wired into the qualified trust account.



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Forward Exchange Mechanics



The Qualified Intermediary is tasked with “Acquiring and Transferring” both properties in the exchange.



TAM 200130001:

Failure to comply with the specific provisions of the safe harbor requirement that the QI “acquires and transfers” the property.



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Forward Exchange Mechanics

Christensen v. Commissioner 142 F.3rd 442 (9th Cir. 1998)

- Taxpayers appealed Tax Court's decision that Taxpayer's transfer of rental property did not qualify as a like-kind exchange because their exchange was completed after the due date of their tax return.
- Taxpayers argued that the Tax Court misinterpreted the Code and that the language "due date determined with regard to extension" should include the extension that is available even if the Taxpayer did not apply for and receive the extension.

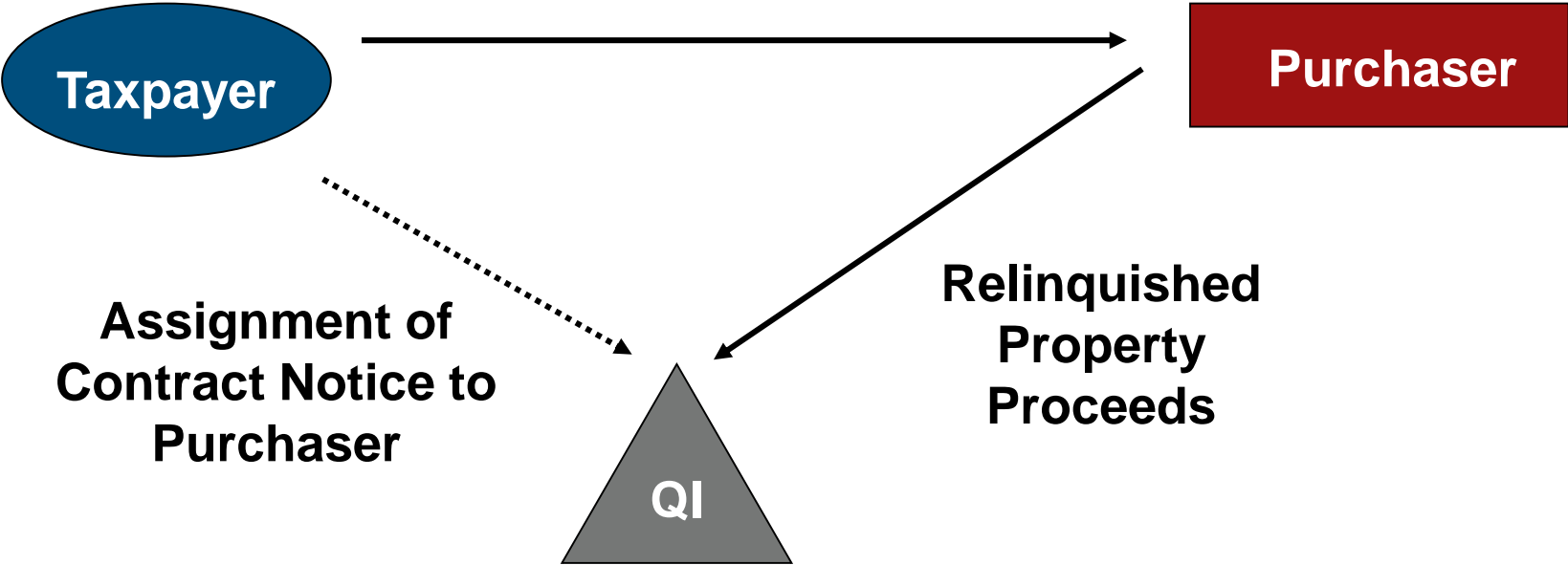


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Forward Exchange Mechanics

STEP 1: Sale of Relinquished Property



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Restrictions on Safe Harbors:“(g)(6)” Restrictions

The Taxpayer must not have the right to receive, pledge, borrow, or otherwise obtain the benefit of the money or other property until:

- The end of the Exchange Period; or
- After the end of the Identification Period if no replacement property is identified;
or
- After the taxpayer has received all of the identified replacement property which it has identified (i.e., to which it is entitled); or



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Restrictions on Safe Harbors:“(g)(6)” Restrictions

The Taxpayer must not have the right to receive, pledge, borrow, or otherwise obtain the benefit of the money or other property until:

If a replacement property has been identified but not received, the Taxpayer will only not be considered “entitled” to the proceeds if a material and substantial contingency related to that property has occurred which:

- Relates to the exchange;
- Is provided for in writing; and
- Is beyond the control of the taxpayer or a disqualified person.



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Restrictions on Safe Harbors:“(g)(6)” Restrictions

What is the impact if a QI ignores the “(g)(6)” restrictions and releases cash to a Taxpayer?

The QI could jeopardize the validity of every other exchange it facilitates.

The Taxpayer could call into question every other exchange it has transacted with the QI.

What if the Taxpayer threatens litigation?

What if the Taxpayer offers to indemnify the QI?



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Identification of Replacement Property

- **3 Property Rule**
Without regard to FMV
- **200% Rule**
Aggregate FMV not to exceed 200% of RQ FMV
- **95% Rule**
Acquire 95% of FMV of identified property



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Structuring a Forward Exchange – Identifying Replacement Property

231 S. LaSalle Street, Chicago, IL

Property may be described by street address, city & state

The Empire State Building

Property may be described by “distinguishable name”

NE Corner of Hollywood & Vine Streets, Hollywood, CA

Property must be “unambiguously described”



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Structuring a Forward Exchange – Identifying Replacement Property

Replacement Property must be designated as such **in written document signed by taxpayer** and hand delivered, mailed, telecopied, or otherwise sent before the end of the identification period to either:

- (1) person obligated to transfer Replacement Property to the taxpayer regardless of whether that person is disqualified; or
- (2) any other person involved in the exchange other than the taxpayer or disqualified person.

Negligence penalty and/or fraud penalty under IRC 6663; criminal charges for delivery of false documents (backdated letter).

Release of exchange funds - g(6) limits rights to receive, pledge, borrow or otherwise obtain benefits of money or other property before end of the exchange period.



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Ethical Issues for IRC Section 1031 Advisors

Identification of Replacement Property

A client's identification period is close to expiring.

The QI suggests your client pre-sign the form indicating the identified properties are attached. The QI will acknowledge the form and your client can submit the attachment any time after day 45.

What ethical obligations do you have?

Are there any extensions or exceptions to the 45-day period?

Does the QI's recommendation satisfy the requirement that the replacement property, when identified, be "unambiguously described"?



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Ethical Issues for IRC Section 1031 Advisors

Ignoring the (g)(6) Restrictions

Your client's QI informs your client that he can cancel his exchange at any time, clearly violating the restrictions required by 1.1031(k)-1(g)(6).

The QI is a potential source of referral business to you as 1031 attorney. What ethical obligations does this raise?

Will the (g)(6) restrictions apply to this transaction?

What issues does this practice raise for the QI (and other taxpayers who use the services of the QI)?



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Structuring a Forward Exchange – Identifying Replacement Property

Dobrich v. Commissioner, T.C. Memo 1997-477

- Taxpayer husband & wife sold investment property in California. They acquired three replacement properties that were not identified to their Qualified Intermediary.
- The transaction preceded the issuance of the Treasury Regulations and the formal guidance re: identification requirements.
- Taxpayer claimed he identified the properties verbally to his wife.



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Structuring a Forward Exchange – Identifying Replacement Property

Dobrich v. Commissioner, T.C. Memo 1997-477

- At trial it was revealed that Mr. Dobrich asked his **real estate broker to back-date offers on the replacement properties so they fell within the 45-day window.**
- None of the properties were listed for sale during the 45-day window.
- The Tax Court found **clear and convincing evidence of intent to commit criminal tax fraud.**



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Structuring a Forward Exchange – Identifying Replacement Property

Smith v. California Franchise Tax Board

- Court of Appeals of California, Fourth District, Division One, October 12, 2018 (unpublished)
- Taxpayer appealed after a judgment in favor of the CA FTB.
- The trial court concluded the **Taxpayer did not timely, or appropriately, identify one of their three acquired replacement properties.**
- The **Court of Appeals agreed** with the trial court that the Taxpayer did not have evidence (except his own deposition which was deemed to be self-serving) that the replacement property was identified timely.
- **Documents from the QI corroborated** the Appeals Court position.



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Reverse Exchange – a.k.a. Parking Arrangement



Revenue Procedure 2000-37

A safe harbor for “Parking Arrangements”

This Rev. Proc. provides a safe harbor under which the IRS will not challenge the qualification of relinquished property or replacement property in certain “reverse exchanges.”



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Reverse Exchange – What is it and Why do one?

- Taxpayer needs or wants to acquire Replacement Property prior to closing on the sale of Relinquished Property.
- Relinquished Property Purchaser's financing fell through.
- Taxpayer's operating company needs a larger facility that requires renovation.
- Taxpayer is an opportunistic buyer and can easily finance the purchase of replacement property without giving up cash flow from existing relinquished property.



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IRS Form 8824 – Reporting the Exchange

Please fill out the following form. You can save data typed into this form. Highlight Existing Fields

Form **8824** **Like-Kind Exchanges** (and section 1043 conflict-of-interest sales) OMB No. 1545-1190
Department of the Treasury Internal Revenue Service **2014**
▶ Attach to your tax return. ▶ Information about Form 8824 and its separate instructions is at www.irs.gov/form8824. Attachment Sequence No. **109**

Name(s) shown on tax return Identifying number

Part I Information on the Like-Kind Exchange

Note: If the property described on line 1 or line 2 is real or personal property located outside the United States, indicate the country.

1 Description of like-kind property given up:

2 Description of like-kind property received:

3 Date like-kind property given up was originally acquired (month, day, year) 3 MM/DD/YYYY

4 Date you actually transferred your property to other party (month, day, year) 4 MM/DD/YYYY

5 Date like-kind property you received was identified by written notice to another party (month, day, year). See instructions for 45-day written identification requirement 5 MM/DD/YYYY

6 Date you actually received the like-kind property from other party (month, day, year). See instructions 6 MM/DD/YYYY

7 Was the exchange of the property given up or received made with a related party, either directly or indirectly (such as through an intermediary)? See instructions. If "Yes," complete Part II. If "No," go to Part III . . . Yes No

Part II Related Party Exchange Information

8	Name of related party	Relationship to you	Related party's identifying number



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IRS Form 8824 – Reporting the Exchange

Please fill out the following form. You can save data typed into this form.

7 Was the exchange of the property given up or received made with a related party, either directly or indirectly (such as through an intermediary)? See instructions. If "Yes," complete Part II. If "No," go to Part III Yes No

Part II Related Party Exchange Information

8	Name of related party	Relationship to you	Related party's identifying number
Address (no., street, and apt., room, or suite no., city or town, state, and ZIP code)			

9 During this tax year (and before the date that is 2 years after the last transfer of property that was part of the exchange), did the related party sell or dispose of any part of the like-kind property received from you (or an intermediary) in the exchange or transfer property into the exchange, directly or indirectly (such as through an intermediary), that became your replacement property? Yes No

10 During this tax year (and before the date that is 2 years after the last transfer of property that was part of the exchange), did you sell or dispose of any part of the like-kind property you received? Yes No

If both lines 9 and 10 are "No" and this is the year of the exchange, go to Part III. If both lines 9 and 10 are "No" and this is not the year of the exchange, stop here. If either line 9 or line 10 is "Yes," complete Part III and report on this year's tax return the deferred gain or (loss) from line 24 unless one of the exceptions on line 11 applies.

11 If one of the exceptions below applies to the disposition, check the applicable box:

- a The disposition was after the death of either of the related parties.
- b The disposition was an involuntary conversion, and the threat of conversion occurred after the exchange.
- c You can establish to the satisfaction of the IRS that neither the exchange nor the disposition had tax avoidance as one of its principal purposes. If this box is checked, attach an explanation (see instructions).

For Paperwork Reduction Act Notice, see the instructions. Form **8824** (2014)



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Second Safe Harbor



Qualified Escrow/ Qualified Trust

Transferee's exchange obligation secured by cash held in a qualified escrow or qualified trust account.

Escrowee/Trustee must not be the Taxpayer or a **disqualified person**.



Taxpayer's rights to receive, pledge, borrow, or otherwise obtain benefits of cash held in the account must be limited in accordance with the “**(g)(6)**” **restrictions**.



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Who can be a Qualified Escrowee or Trustee?

A “Disqualified” Person is anyone who is:

The **agent of the taxpayer** at the time of the transaction.

Has acted as taxpayer’s **employee, attorney, accountant, investment banker, real estate agent, or broker within the two-year period** ending on the date of the transfer of relinquished property.

Is “related” to the taxpayer as described in IRC Section 267(b) or Section 707(b) determined by substituting **10% for 50%** each place it appears.

Bears same relationship with person described in third bullet point.



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Third Safe Harbor



Qualified Intermediary

This is the only method of achieving Safe Harbor treatment for the statutory requirement that **an exchange must be a reciprocal transfer of properties** as distinguished from a taxable sale and reinvestment.

The Qualified Intermediary agrees to “**acquire and transfer**” both properties in the exchange.



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Ethical Issues for IRC Section 1031 Advisors

Taxpayer advises her attorney that she intends to do a like-kind exchange and requests specific language be inserted into her PSA to reflect that.

Is the attorney obligated to ensure the net sale proceeds are sent to a Qualified Intermediary?

Is the attorney obligated to do any due diligence on the Qualified Intermediary?

Is the attorney obligated to track the critical dates for this transaction?



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Exchange Requirement – Role of the QI

A Qualified Intermediary is an unrelated third party who is not the Taxpayer or a Disqualified Person who acts to facilitate a deferred exchange.

- 1. The QI becomes the party with whom the Taxpayer exchanges its properties;**
- 2. The QI uses a bank account, an escrow account or a trust account to help the Taxpayer avoid the issue of constructive or actual receipt of the sale proceeds;**
- 3. The QI provides the Taxpayer with all of the documentation required to structure the exchange as a safe harbor transaction.**



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Ethical Issues for IRC Section 1031 Advisors

Selecting a Qualified Intermediary

In a safe harbor forward exchange, what is your duty to interview and vet your client's preferred Qualified Intermediary?

Defalcations during the recession revealed flaws in some QIs structures (as well as outright theft).

Safe Harbor options include the use of a:

Qualified Bank Account;

Qualified Escrow Account; or

Qualified Trust Account.

Does a Fidelity Bond or a parent company guarantee provide additional protection from defalcation?



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Ethical Issues for IRC Section 1031 Advisors

Referring a QI to a Client

In a safe harbor forward exchange, if you refer your client to a Qualified Intermediary who files for BK, or steals your client's funds, can you be held liable for a negligent referral?



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Ethical Issues for IRC Section 1031 Advisors

QI who is also an Attorney

The QI company is owned or managed by an attorney. The QI's website indicates that the QI does not provide legal or tax advice.

If the QI tells a taxpayer that they cannot contribute a tenancy in common interest to a partnership for two years after acquisition, is the QI providing tax advice?

Is the QI subject to the rules of ethics?



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Ethical Issues for IRC Section 1031 Advisors

QI who is also an Attorney

An attorney can serve as QI only if the attorney's services are in connection with the exchange of property intended to qualify for non-recognition of gain under IRC Section 1031.

What if a QI advises a client that an LLC can add new members to the entity prior to acquiring replacement property?

What if a QI advises a client that the acquisition of 100% of the membership interests in an LLC that owns property is treated as the acquisition of the underlying real property?



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Ethical Issues for IRC Section 1031 Advisors

QI who is also an Attorney

QIs and their clients are parties to a service agreement.

Is the QI obligated to disclose any conflicts of interest prior to providing legal or tax advice?

If the IRS requests information from a QI, do the rules of confidentiality apply?
Must the QI turn over information?

If a QI charges a fee and retains interest earned on the sale proceeds, does the QI need to disclose the amount of interest is retains?



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Ethical Issues for IRC Section 1031 Advisors

NY Rules of Professional Conduct: Conflicts of Interest 1.7(a)[A]

A lawyer shall not represent a client if a reasonable lawyer would conclude that ...
(2) there is a **significant risk** that the lawyer's professional judgment on behalf of a client will be adversely affected by **the lawyer's own financial**, business, property, or other personal interests.



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Qualified Intermediary – Initiating the Exchange



Security

- Security should be a client's most important concern. Select a Qualified Intermediary that can be trusted with client funds

Service

- Clients need to work closely with the QI. Make sure they provide top customer service



Experience

- A client depends on the QI to properly document and facilitate the 1031 Exchange

Price

- Be sure to look at the amount of the exchange fee, including all hidden costs



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Thank you for attending!

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