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IRC §1031 Tax-Deferred Exchanges

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EVP, Certified Exchange Specialist(r) at CDEC 1031 Exchange...

What you will learn today…

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

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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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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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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.

Held for Investment Requirement

- For purposes of section 1031, neither the Code nor the regulations define “held for investment.”

- The regulations provide that “[u]unproductive 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 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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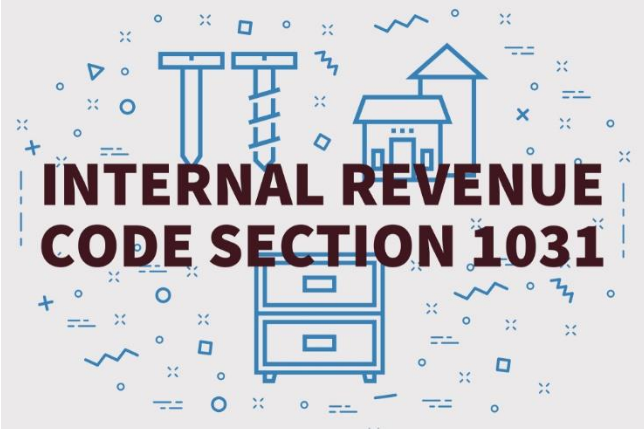
Held for Investment Requirement

What does “held for investment or for productive use in a trade or business” mean in the context of an IRC Section 1031 tax-deferred exchange?



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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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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.**

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.

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.

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.

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

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 <u>and</u> 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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Qualifying Property

<u>Properties that **DO** Qualify</u>

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

<u>Properties that **DO NOT** Qualify</u>

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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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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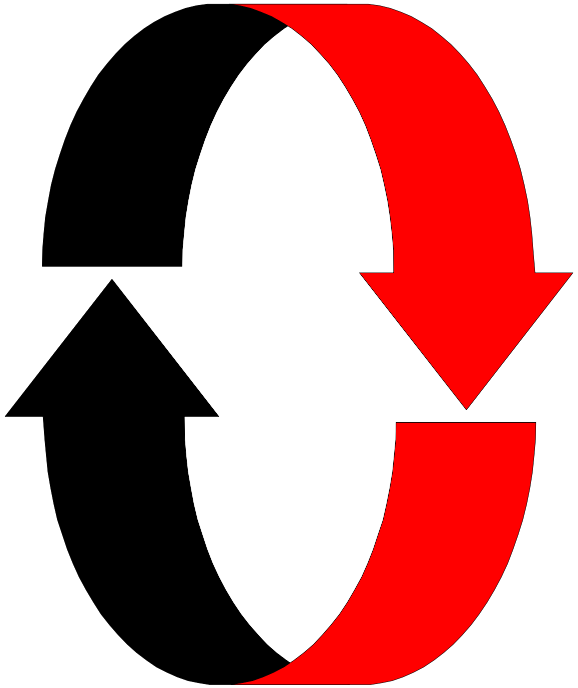
The Exchange Requirement

- 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.



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
$ 50,000	+ Capital improvements made
$ 950,000	Adjusted Cost Basis

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

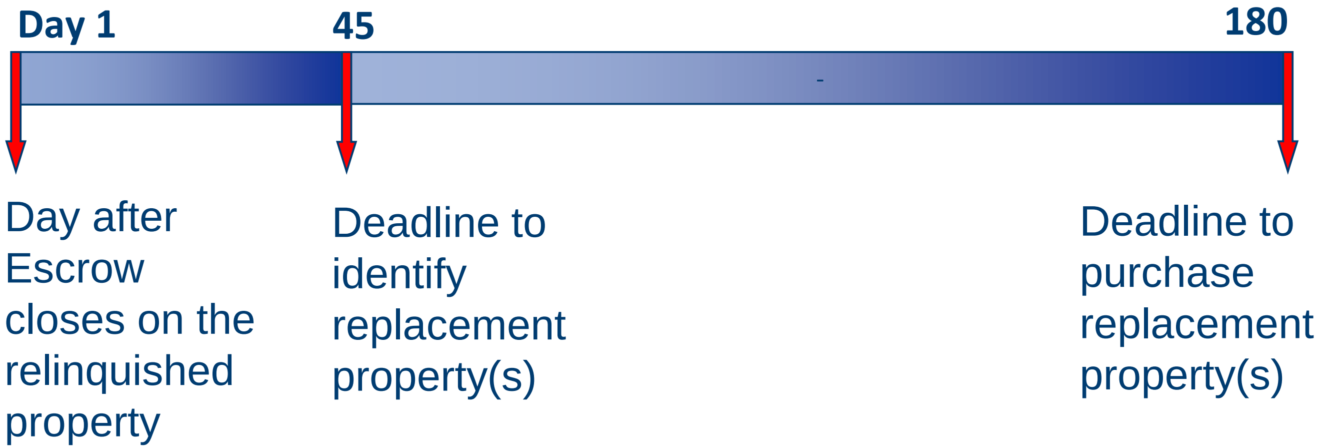
Equity+ : $1,250,000

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

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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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 <u>on or before</u> the date of the federally declared disaster, or in a Reverse exchange, qualified indicia of ownership transferred to EAT <u>on or before</u> 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 insurance due to disaster

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

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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.

Forward Exchange Mechanics

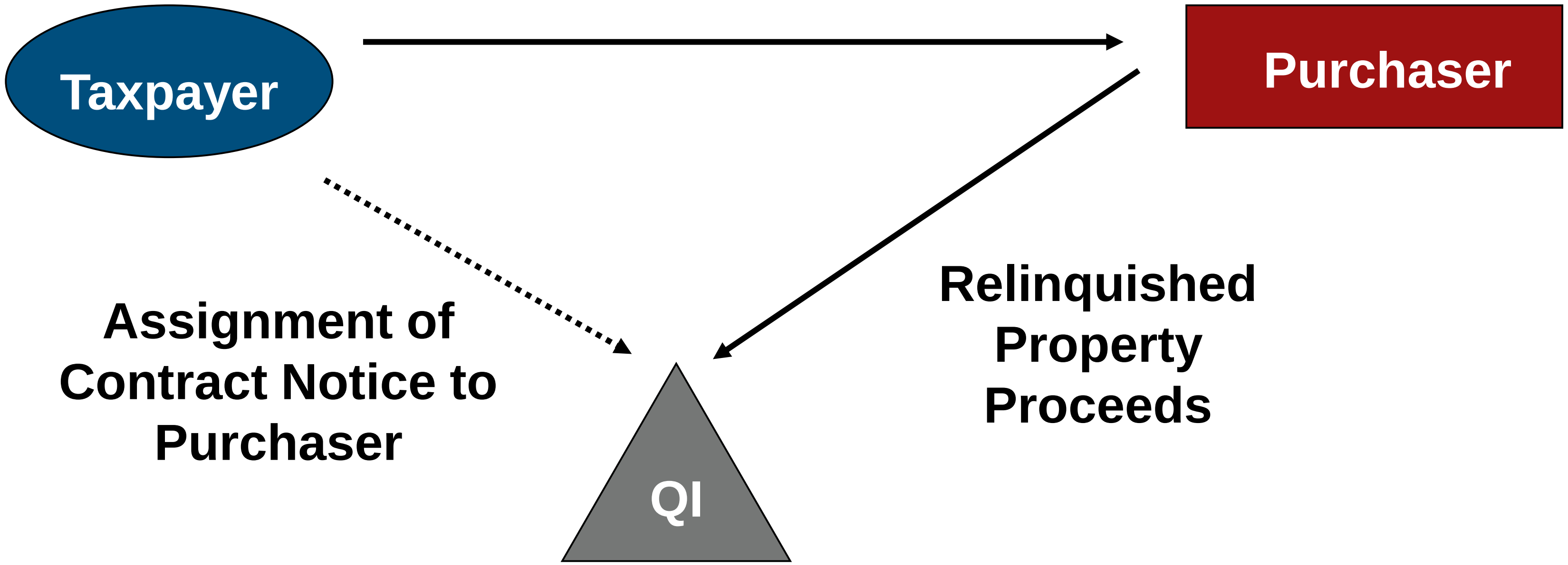
The Qualified Intermediary is tasked with “Acquiring and Transferring” both properties in the exchange.

TAM 200130001:

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

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:

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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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.

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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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.”

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.

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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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.

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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