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Mastering 1031 Exchanges

Navigating complexities and unlocking opportunities for your clients

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About Your Presenters

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Objectives

Review of 1031 Exchange Basics

Complex Issues & Solutions: Recurring Issues in 1031 Exchanges

Reverse Exchanges: Benefits and Process

Build-to-Suit Exchanges: Advantages and Process

Tax & Economic Policy & 2025 Tax Legislation

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Review of 1031 Basics

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Definition Of Like-kind – IRC Section 1031

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

Typical Real Estate Transaction

Typically, when someone sells investment property aka land, and there is a capital gain (profit), the seller pays capital gains tax in the year of sale.

A 1031 exchange allows the seller to defer payment of the capital gains tax.

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Tax Deferral, Not Tax Avoidance

A 1031 Exchange allows the property owner to potentially defer four levels of taxation:

- Tax on depreciation recapture (25%)
- Federal Capital Gain (15% to 20%)
- State income taxes (up to 13.3%), if applicable
- Net Investment Income Tax (NIIT), if applicable

Equal Or Greater Value

- Replacement property(ies) must be of equal or greater value to exchange value of relinquished property
- Exchange value determined by subtracting closing costs and broker’s commissions from relinquished property(ies) value
- Exchange value not used in acquiring replacement is “boot” and taxable
- Equity AND Debt must be replaced

Types Of Exchanges

Forward Exchange

Sell investment property and, within 180 days, complete the purchase of new investment

Reverse Exchange

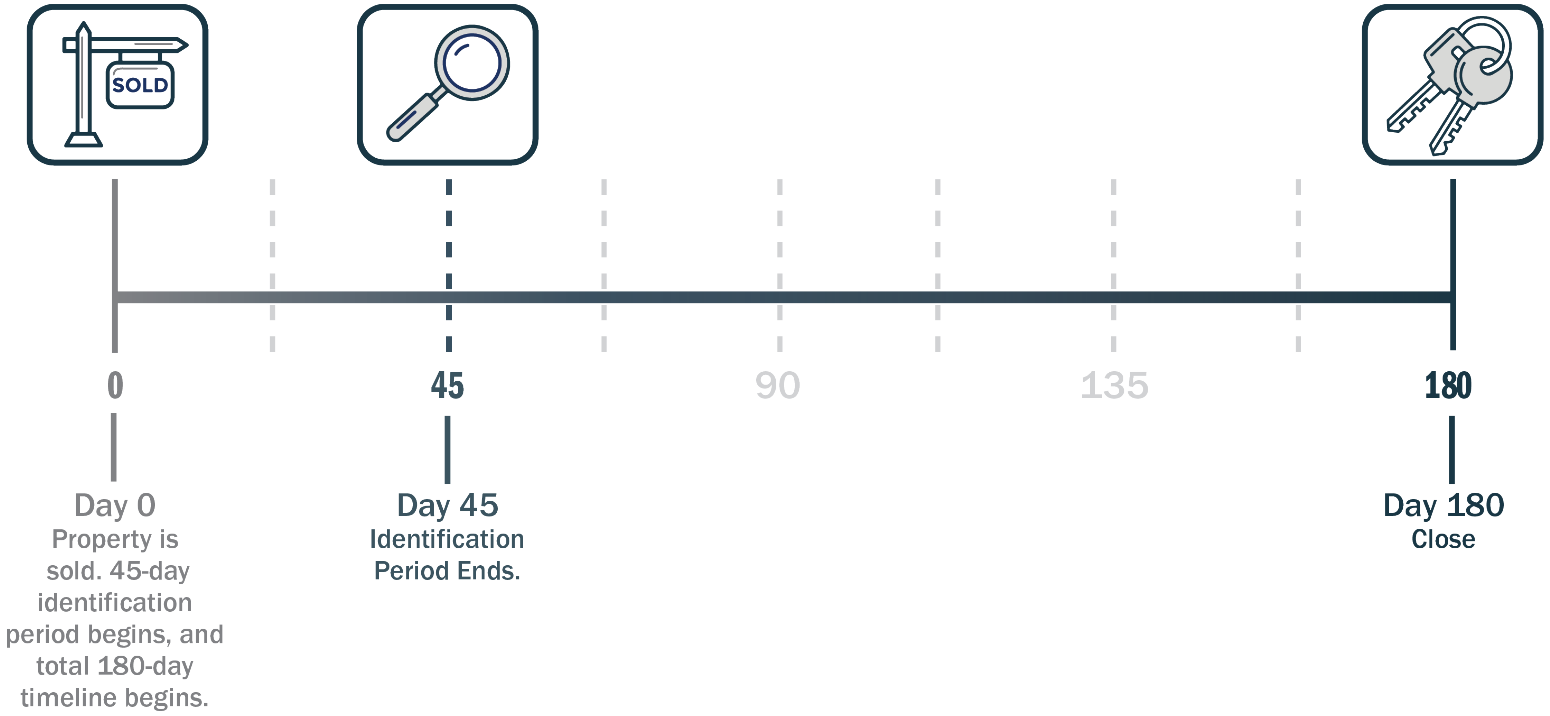
Purchase of new investment property occurs before sale of original investment property (must complete within 180 days)

Improvement Exchange

Sell investment property, use accommodator to acquire and hold property while improvements are made.

Can be structured as forward or reverse

The Timeline



Funds received from the sale of the RQ property remain with the QI until the RP property is purchased, or 180 days is reached.

Three Rules when describing the specified property:

1. Unambiguous
2. In writing
3. Submitted to the QI

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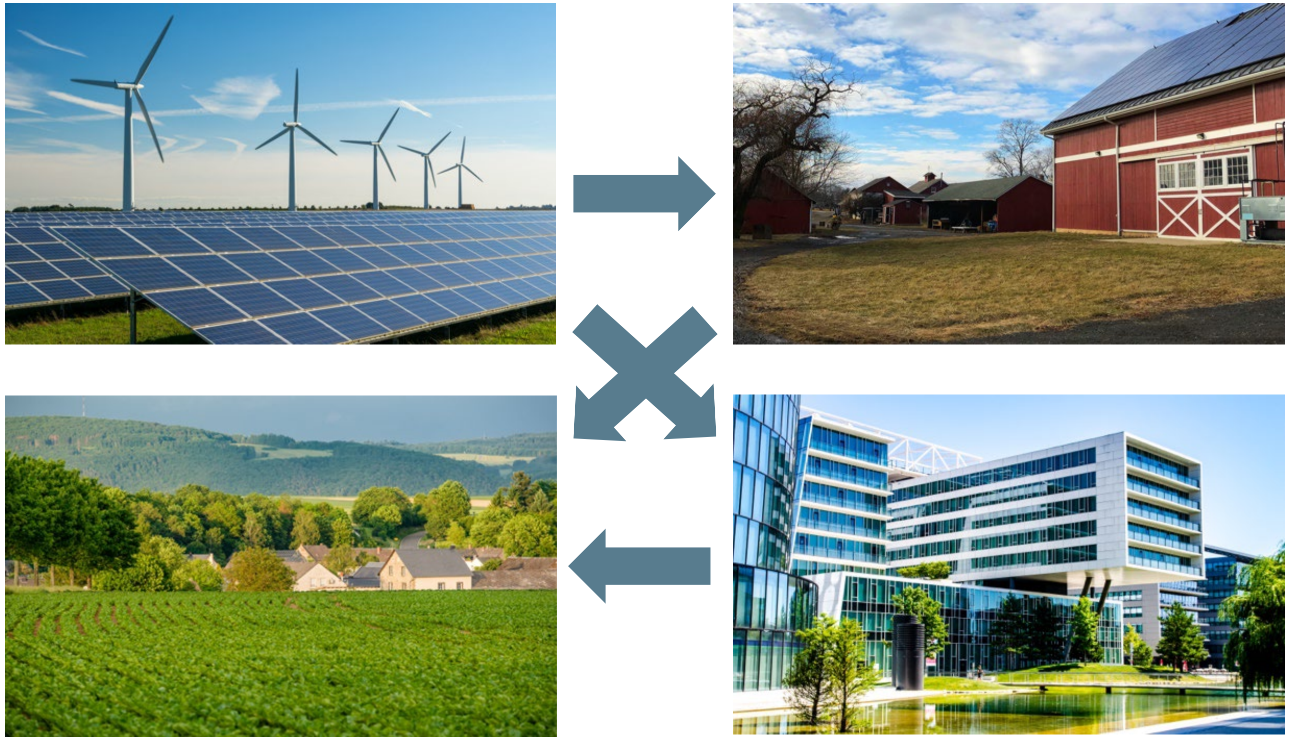
Replacement Property Identification

3 ways to identify potential replacement property

3 Property Rule	**Up to 3 properties of any value**
200% Rule	**Any number of properties (greater than three) so long as aggregate value does not exceed 200% of the relinquished property value**
95% Rule	**If Exchanger fails first two rules, they must acquire at least 95% of the value of all properties identified**

Examples Of Like-kind Property

Farmland
Ranchland
Hunting/Recreational Land
Timberland
Vacant Land
Easements (Conservation and others)
Mineral, oil, and gas rights
Water and timber rights
Wind and Solar farms
Billboard sites
Cell tower sites
Other Property Types



REALTORS® Motivation For A 1031 Exchange

- Exchangers are often cash buyers
- Exchangers are Buyers on a strict timeline
- Exchangers often own multiple properties
- Ability to showcase knowledge & resourcefulness to clients
- Typically less emotional and more sophisticated transactions
- You create a niche in the industry
- Guaranteed transaction to maintain a valid 1031 exchange
- 1 sale may turn into multiple purchases!

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Complex Issues & Solutions

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Qualified Use

Business use or investment

- Holding bare land to appreciate = “held for investment”

Holding period

- No specific length of time; matter of Exchanger intent

No “dealer/developer” property “held primarily for sale”

Vacation homes or second homes do not qualify

Changing title/liquidating entity before sale may disrupt qualified use

Personal Use Property

Exchanger's Intent is key

IRS Safe Harbor Rules For Personal Use of Rental Property

- Replacement Property must be held for at least 2 years
- Taxpayer must rent the replacement property for a minimum of 14 days in each of the 2 years; and
- Taxpayer's personal use must not exceed 14 days or 10% of the number of days property is rented, whichever is greater.
    - Rev. Proc. 2008-16 and 14 day *de minimus* rule

Real Property Under The 2020 Regulations

Treasury Regulation §1.1031(a)-3 were enacted 12-2-2020

- It is entitled "Definition of real property"

Property is real property if it is:

- Classified as real property under state or local law
- Specifically listed as real property in the final regulations, or
- Considered real property based on all of facts and circumstances, under factors provided in the regulations

<u>ALL LAND IS ELIGIBLE FOR A 1031 EXCHANGE.</u>

Improvements To Land

According to the new Regs, to be part of the real property, improvements must be permanently affixed

- Affixation is considered permanent if it is reasonably expected to last indefinitely based on all the facts and circumstances
- Lengthy list of examples

Items not on the list can be “an inherently permanent structure” by considering the following factors:

- How it is affixed to the real property;
- Whether designed to be removed or remain in place;
- Damage that removal would cause to itself or the real estate;
- Whether the affixation was intended to be indefinite; **and**
- Time and expense needed to remove the item (weight alone may suffice)

Examples of Improvements to Land

Real property improvement examples you could acquire in your exchange include:

- Center pivot irrigation systems
- Fencing
- Well
- Septic
- Site-prep
- Foundations
- Shops
- Homes, outbuildings, prefab that is affixed to the land, etc.

Easements, Leaseholds & Licenses

An easement of **any** duration is an interest in real estate

- However, to be considered like-kind to a fee ownership, the easement **must** be perpetual

Leasehold interests are defined as real estate

- Must have a remaining term of 30 years or more to be like-kind with a fee ownership interest

Licenses and permits are considered real property if solely for the use and enjoyment of land or a building

- A license to enter land to extract minerals
- Federal or State permits and leases

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Mixed-Use Land

Interplay of Section 121 *Exclusion* and Section 1031 *Exchange*

- More Art than Science
- Need to substantiate the value of Primary Residence
- Current Market Analysis (CMA)

Farmstead or Homestead that encompasses principal residence.

LLC or Corporate ownership of the principal residence?

Settlement statement preserves continuity.

Allocate debt payoff to principal residence component to reduce debt replacement obligations.

Personal Property

Inherent tension in Allocation of Values

Depreciation Recapture vs Immediate Expensing

Partnerships & Fractional Interests

While Section 1031(a)(2)(D), regarding exchanges of partnership interests, has been repealed, partnership interests still cannot be exchanged.

- They are intangibles, and thus ineligible.
- Exception: Section 761(a) elections out of Subchapter K still work.

TIC interests and Delaware statutory trust (DST) guidance is still favorable and controlling.

- Those offerings should be unaffected, as they were largely all real property.

Same with oil, gas & mineral royalty trusts.

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Disregarded Entities & Fractionalized Interests

Acquiring 100% interest in a single-member limited liability company is treated as an asset acquisition (PLR 201216007)

- Need remains for "closing" in spite of lack of deed

Acquiring a beneficial interest in a grantor trust is treated as acquiring an undivided interest in the trust's assets (Rev. Rul. 2004-86)

- Acquisition DST interests

Acquisition of TIC interests

Other Recurring Exchange Issues

Drop and Swap vs. Swap and Drop transactions

- IRS maintains position on this issue

Qualified use" requirements-holding period

- Red flag in sale of property held less than 2 years

Low Inventory

Accelerated Transaction Timelines

- No exceptions

Related Party Transactions

- No cash out event and 2 year hold

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Reverse Exchanges:
The Ultimate in Complexity!

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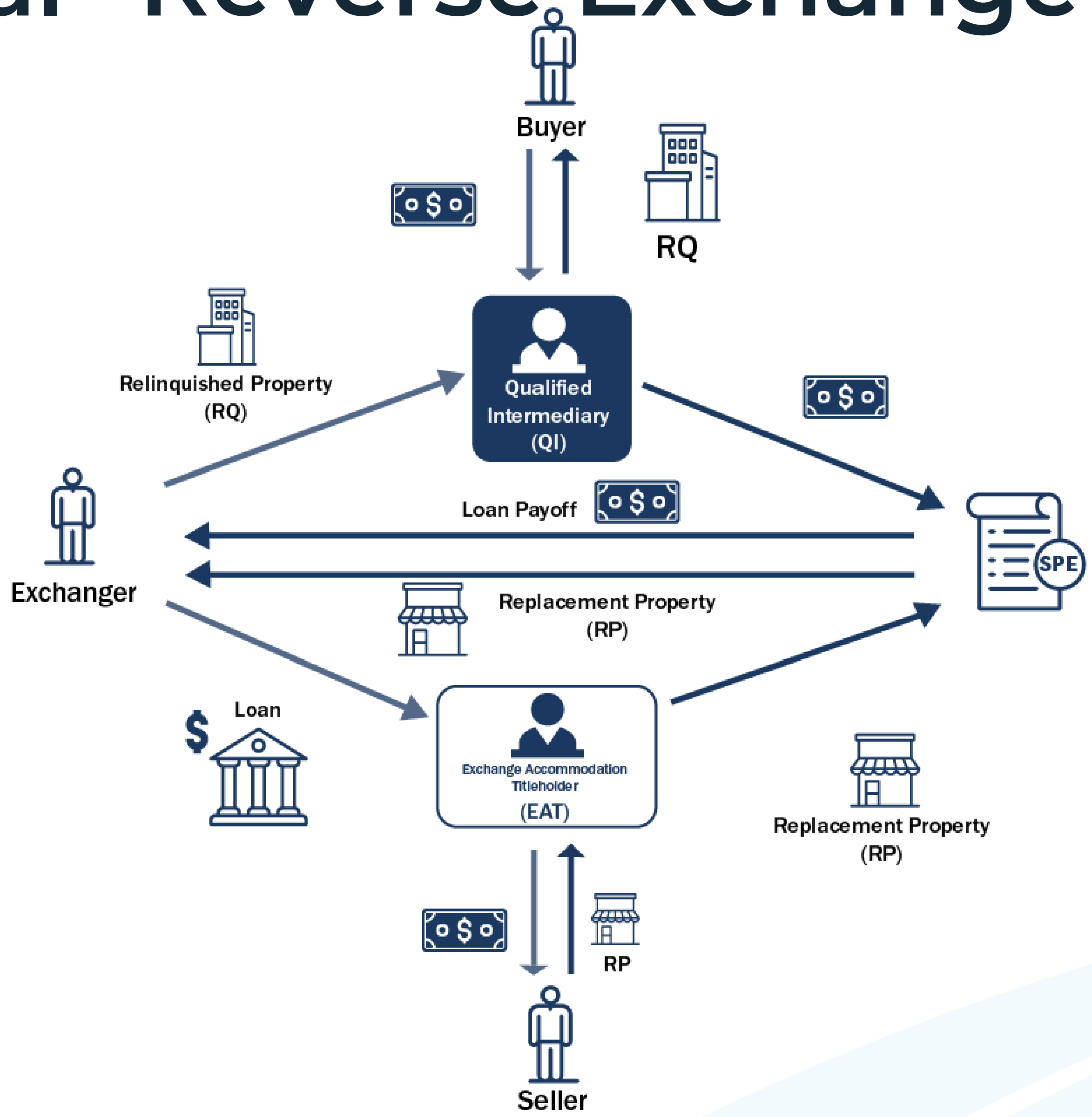
Reverse Exchanges

Why do we facilitate Reverse Exchanges?

- Market Conditions & Advantageous acquisitions
- Relinquished property sale has fallen apart
- Construction requirements
- Delays in completing conservation easement grant

“Typical” Reverse Exchange



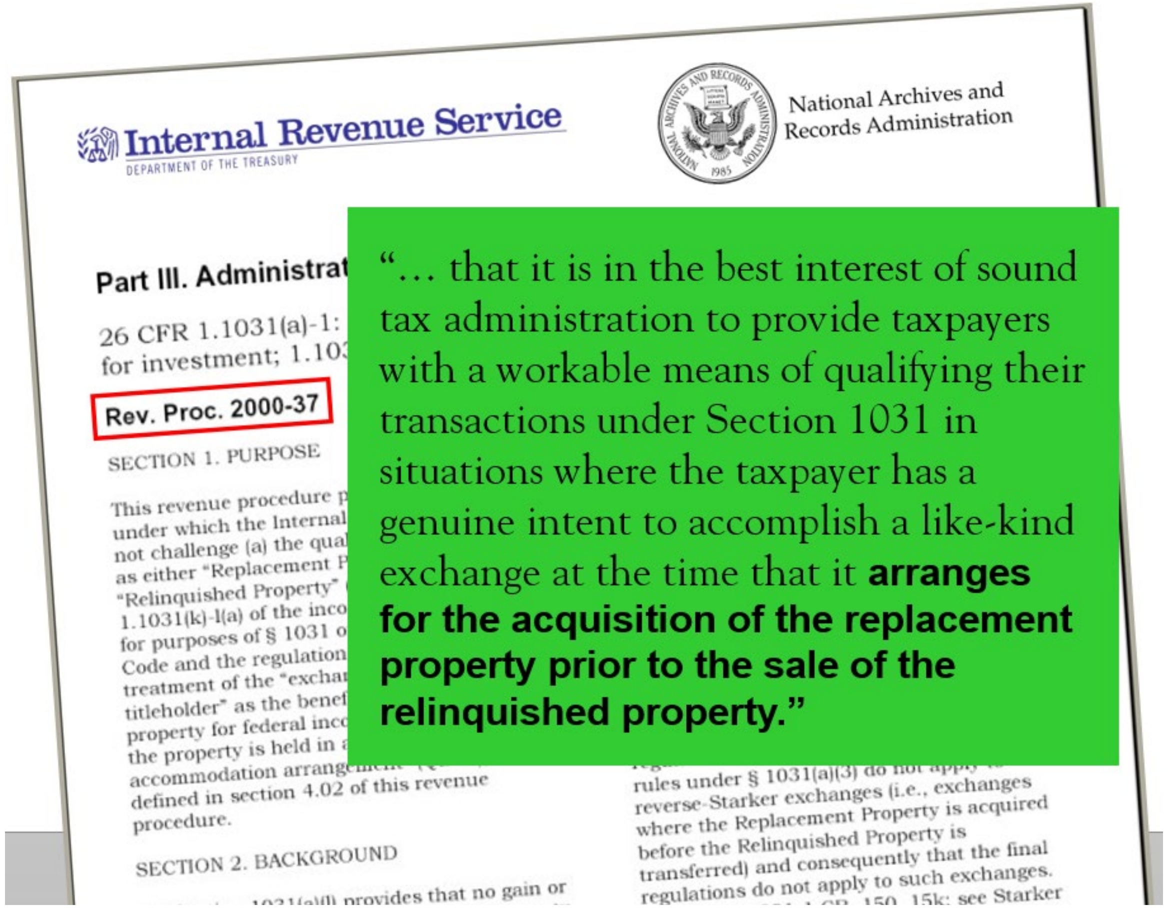
Alternatives To Reverse Exchanges

Look for Simplification if Possible

Reverse Exchange Alternatives

- Negotiate to Buy Time
- Add earnest money
- Option Agreement
- Hard money deposits

Revenue Procedure 2000-37



"… that it is in the best interest of sound tax administration to provide taxpayers with a workable means of qualifying their transactions under Section 1031 in situations where the taxpayer has a genuine intent to accomplish a like-kind exchange at the time that it **arranges for the acquisition of the replacement property prior to the sale of the relinquished property.**"

The Basics of Reverse Exchanges

Rev. Proc. 2000-37

- Explains what we don’t do in a NSH or specialty transaction

Issues in selecting a parking entity

- Not disqualified person
- Not related person
- Subject to tax reporting
- More expensive than forward exchanges

Reverse Exchanges – Relinquished Property

To avoid the taxpayer taking title to property prior to the sale of the relinquished property, regulations suggest "parking" the title by a paper sale of the RQ property to an exchange company to trigger a sale prior to the purchase of the RP property.

- The document required for compliance with this safe harbor procedure was known as the Qualified Exchange Accommodation Agreement, (aka the Reverse Exchange Agreement).

- The party providing the service was known as the Exchange Accommodation Titleholder (EAT).

Permitted arrangements include

- The taxpayer can lend necessary funds to the EAT.
- Property can be leased from EAT to taxpayer.
- Taxpayer can manage the property.
- The parking arrangement can only be done up to 180 days during which time the taxpayer has to sell the RQ property to a BFP.
- Whenever the RQ property is sold to the BFP by the EAT, the sale proceeds are transferred back from the EAT to the taxpayer as payoff of the initial financing provided to the EAT.
- There is a provision to “true-up” the value of the property where beginning estimation differs from actual value upon sale to the BFP.
- The EAT normally takes ownership via a SPE LLC.

Reverse Exchanges: Which Property to Park?

- What are the respective values?
- Difficult to estimate the value of the RQ property.
- Only "equity" portion of the RQ property needs to be covered.
- Are there environmental issues with either property?
- Transfer Tax Considerations.

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Build-to-Suit and Improvement Exchanges

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Improvement/Build-to-Suit Exchanges

An exchange in which the taxpayer desires to build-upon or make improvements to the replacement property using their 1031 Exchange funds

Taxpayer gets credit for the land and improvements value.

Timing is everything

- If the acquisition of the property and making of improvements begins prior to the sale of the taxpayer's RQ property, it is known as a Reverse Build-to-Suit or Property Improvement Exchange.

- Just as in the case of a routine reverse exchange, parking the subject property with an EAT will allow the taxpayer to technically avoid receiving the property before the completion of the forward exchange.

- The safe harbor requires the use of a QEAA and an EAT.

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Specialty Exchange Transactions

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Specialty "Non-safe Harbor" Transactions

The "No Inference" Language of 2000-37

- Section 3.02 Scope…
  - No inference. No inference is intended with respect to the federal income tax treatment of arrangements similar to those described in this revenue procedure that were entered into prior to the effective date of this revenue procedure. Further, the Service recognizes that "parking" transactions can be accomplished **outside of the safe harbor** provided in this revenue procedure. Accordingly, **no inference is intended** with respect to the federal income tax treatment of "parking" transactions that do not satisfy the terms of the safe harbor provided in this revenue procedure, whether entered into **prior to or after** the effective date of this revenue procedure.

Thus, it is possible to structure a reverse exchange outside of the safe harbor provided by Revenue Procedure 2000-37.

Key Factors In Non-Safe Harbor Deals

These deals are NOT governed by Rev. Proc. 2000-37!

What are True Benefits & Burdens of ownership?

- DeCleene v. Commissioner (US Tax Court 11-2000) (1993 facts)
- Rev. Proc. 2000-37 not applicable so general tax law principals prevail
- Only bare transfer of title to accommodating party (AP)
- TP obtained construction debt, no recourse debt or at-risk equity from AP, no interest on debt, no real estate tax liability, no recognition of value of improvements conveyed (exchange value of $142,000)

What can we infer from DeCleene?

- At risk debt or equity investment
- Independent Project Managers and General Contractors
- No leases to Taxpayer
- No lending by Taxpayer

The Bartell Case & Non-Safe Harbor Parking Arrangements

In the fall of 2016, the decision in the *Bartell* case was handed down from the Ninth District Circuit Court. The Court held in favor of the taxpayer and noted the following:

- Taxpayer retained the benefits and burdens of ownership.
- Taxpayer was entitled to appreciation over the exchange period.
- Taxpayer held risk of loss in the event of a downturn.
- Taxpayer lent funds to the accommodator.
- Taxpayer financed and directed construction. Taxpayer had possession of the property under a lease.
- Parking arrangement provided for 24 months.

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Takeaways from the Bartell Case

- The Court was very liberal on relationship of the parties that were part of a safe harbor deal.
- Parking non-safe harbor arrangement should not provide for a term greater than 24 months.
- The Ninth Circuit Court ruling is not binding on other courts.
- The facts in the case preceded the year 2000 parking exchange regulations.
- The IRS chose not to appeal the decision.

Specialty Build-to-Suit Property Exchanges

- Taxpayer gets credit for the land and improvement's value, but the improvements do not need to be completed at the time the property is turned over to the taxpayer.
- While a taxpayer cannot acquire RP property from a related party, there is a technique to allow building upon land owned by a related party through the use of a ground lease.
- A long-term lease is entered into between the related party and the EAT. pursuant to which the EAT makes the desired improvements and the EAT's leasehold estate is transferred to the taxpayer.

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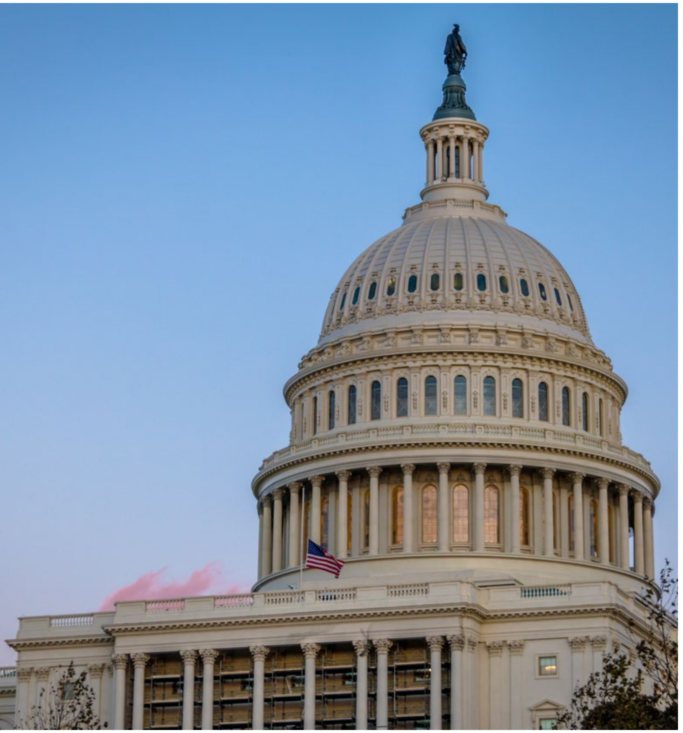
Economic Studies Regarding Tax-Deferred Exchanges



In March 2015, Ernst & Young published *Economic Impact of Repealing Like-Kind Exchange Rules*

- Repealing like-kind exchange would slow economic growth, shrink investment, and reduce the GDP (even if combined with lower tax rates).
- The ten most impacted industries would see a decline in annual GDP of $27.5 billion.

In July 2015, the Ling-Petrova *Microeconomic Study* is released.

- Nearly 88% of exchanged real estate replacement properties are eventually disposed of in a taxable sale.
- Exchanged properties later sold in a conventional, taxable sale produce an increase of approximately 19% in taxable gain over non-exchanged properties subsequently sold in a conventional sale.

1031 Exchanges & The Economy

- Efficient Use of Cash Flow
- Promotes Domestic Investments
- Encourages the Free Flow of Real Estate Transactions
- Provides Continuity of Income Producing Investments
- Taxes Will Be Paid - One Way or the Other
- 1031 Exchanges Create More Jobs
- 2024 Elections & 1031 Exchanges in 2025 & Beyond

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Thank you!

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