

1031 Exchange: Practical Solutions to Common Situations

Presented by Matthew Douglas, JD
& Martin Edwards, JD



Definition IRC § 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.”

Exchange Properties Involving Personal Use

Common Questions On Vacation Homes



**DOES MY SECOND
HOME, OR VACATION
HOME QUALIFY FOR A
1031 EXCHANGE?**



**HOW LONG DID I
HAVE TO HAVE
HELD THE FORMER
RESIDENCE AS AN
INVESTMENT
PROPERTY PRIOR
TO THE EXCHANGE**



**DOES SOME
PERSONAL USE
TRUMP THE
INVESTMENT USE
OF THE PROPERTY?**

Common Questions on Personal Use



**CAN I USE
PROPERTY TO
FIX IT UP?**



**HOW
LONG PER
YEAR DOES
IT HAVE TO BE
RENTED**



**WHAT ABOUT
IF IT IS ONLY A
SEASONAL
RENTAL?**



**Sale of: Exchange
Property When
Former
Residence/Current
Residence When
Former Exchange
Property**

Personal Use: Rev Proc 2008-16

When selling Relinquished or buying Replacement property involving some aspect on personal use property a myriad of questions can arise.

The IRS attempted to provide some definitive guidance regarding some of these questions in the form of **Revenue Procedure 2008-16**. As the IRS aptly put it:

- “The Service recognizes that many Exchangers hold dwelling units primarily for the production of current rental income, but also use the properties occasionally for personal purposes. In the interest of sound tax administration, this revenue procedure provides Exchangers with a safe harbor under which a dwelling unit will qualify as property held for productive use in a trade or business or for investment under §1031 even though a Exchanger occasionally uses the dwelling unit for personal purposes.”

Personal Use Requirements

An Exchanger's vacation home or second residence can be eligible for a 1031 exchange if specific requirements are met:

- **Relinquished Property:**

- Owned by Exchanger for 24 months immediately before Exchange
- Must have been rented at FMV for a minimum 14 days for each 12 month period
- Exchanger cannot have used the property personally for more than 14 days or 10% of the days rented for each 12 month period (greater of the two applies)

- **Replacement Property:**

- Owned by Exchanger for at least 24 months immediately after Exchange
- Must have been rented at FMV for a minimum 14 days for each 12 month period
- Exchanger cannot have used the property personally for more than 14 days or 10% of the days rented for each 12 month period (greater of the two applies)
- The Exchanger can use the relinquished or replacement property for additional days if the use is for property maintenance or repair.***

Sale of Replacement Property Formerly Owned as a Personal Residence

Exchanger owns property for a period of time as principal residence but eventually converts it to rental property and later sells the property - §121 Opportunity?

- Property must have been owned for a total of at least 5 years
- Must subtract from the total time period the years it was held as exchange property
- In the case of a total gain of \$200,000 with a total hold of 7 years, with the example of a three year exchange period, multiply the whole gain by the fraction where the numerator is the exchange years and the denominator is the total number of years held $\frac{3}{7} \times \$200,000$ for the taxable amount (\$85,714) not eligible for the §121 homeowner exemption

Sale of Personal Residence Formerly Owned as an Exchange Property

- Under §121 so long as the property has been used by the Exchanger as the primary residence for at least the immediate two years preceding the sale the §121 exclusion can still be used to the limits of the code section
- In the event gain still exists, the balance may still be deferred by doing a 1031 exchange for the remaining amount by combining the two code sections
- We have heard of situations where Exchangers make annual gifts under gift tax exclusion amount to family member which is used as source for payment of rent (best to discuss with TP accountant)

Leasing Exchange Property to a Family Member

- It is not uncommon for an Exchanger to wish to acquire replacement property with the intent to lease it to a family member. Examples include sending a child away to college or wishing to house an elderly parent
- Most persons are aware that a Exchanger cannot buy replacement property from a related party but no such restriction against renting to a family member exists
- Very important that any rent be paid at FMV and reported by Exchanger as rental income

1031 Exchanges Straddling Two Tax Years

Many Exchanges are Begun in One Tax Year and Concluded in the Next

- For taxpayers who sell after October 19th who need the full 180 days, they must file an extension by April 15th
- For taxpayers who sell property after July 5th, identify possible replacement property but receive all or some of the exchange funds back upon expiration of the 180 day period in the next tax year, the default tax reporting is to report the gain in the subsequent tax year, i.e. the year in which the funds are received
- Similarly, for persons who sell after November 16th and fail to identify replacement property resulting in distribution the following tax year same rules apply
- Must be a bona fide intent to do an exchange not just to kick the tax payment to the next tax year
- An IRS Form 6252 should be filed with the taxes for the year of the sale to let the IRS know the sale will be reported as an installment sale in the second year
- Any tax due on debt relief or recapture of depreciation

Seller Financing

Seller Financing as Part of A 1031 Exchange

- The form of the seller financing can be structured in ways other than a Note secured by a security instrument
- These alternatives are basically all the same as each other but are just known by different names:
 - Contract for Deed
 - Installment Agreement for Deed
 - Articles of Agreement for Deed
- Generally, the mechanics of transfer to the Exchanger are a bit easier if a Note and security instrument are used

Seller Financing Cont'd

- The loan from the Exchanger usually has a long-term amortized repayment or a semi-long term balloon payment
- Problem is the Exchanger must use that value into his Replacement property purchase before monetizing it
- If the Exchanger's Replacement property seller would agree to receive the Note as part of the purchase price, that would work
- A more usual solution is for the Exchanger to acquire the Note from the QI by replacing the amount of the Note with fresh cash
- The cash is then used to acquire the Replacement property
- QI can sign a document agreeing to endorse over the Note
- After Replacement property is acquired, the Note is endorsed or assigned to the Exchanger

Note Purchase Agreement Example

This instrument is to be used in the event the Note is later sold by the Qualified Escrowee for cash.

NOTE PURCHASE AGREEMENT

THIS NOTE PURCHASE AGREEMENT (this "Agreement") is made and entered into this _____ day of _____, between ACCRUIT, LLC AS QUALIFIED ESCROWEE AND CURRENT HOLDER OF NOTE ("Seller"), and _____ ("Purchaser").

For good and valuable consideration, the receipt and sufficiency of which is hereby acknowledged, Seller hereby grants, bargains, sells, assigns, transfers and sets over unto Purchaser, its successors, transferees and assigns forever, all of the right, title and interest of Seller in and to (a) that certain Promissory Note annexed hereto as EXHIBIT A ("Note"), together with (b) that certain Mortgage or Trust Deed (the "Trust Deed") dated of even date with the Note securing the obligations of the Note.

Seller agrees to deliver to Purchaser the original Note endorsed "PAY TO THE ORDER OF [PURCHASER] WITHOUT RECOURSE", upon demand, provided however that in the event this transaction is part of a tax deferred exchange transaction and the Purchaser hereunder is the "Exchangor" under a Tax Deferred Exchange Agreement with Accruit, LLC, as Qualified Intermediary, then notwithstanding anything hereunder to the contrary, Purchaser shall not be entitled to receive said Note until after the "End Date" as defined in Paragraph 1.4 of said Exchange Agreement hereby incorporated by reference.

This sale of the Note and Trust Deed is made without recourse, representation or warranty of any kind, express or implied, except that Seller represents to Purchaser that (a) Seller is the lawful holder of the Note and the Trust Deed and is duly and legally authorized to sell, transfer, convey and assign its rights therein; (b) Seller has not modified the Note or the Trust Deed in any material respect, or executed any instruments of release, cancellation or satisfaction; and (c) Seller has not made any prior assignment, conveyance, transfer or sale of any of its rights or interests in the Note or the Trust Deed.

Purchaser hereby accepts the foregoing sale, assignment and transfer.

IN WITNESS WHEREOF, the parties have executed this Agreement as of the date set forth above.

Accruit, LLC as
Qualified Intermediary

By: _____

Its: _____

PURCHASER

Endorsement of Note Example

**Attachment to and Endorsement dated February 21, 2024 of
Note dated October 31, 2023 in the amount \$1,268,000.00 from
Chicago Real Estate Holdings LLC to Accruit LLC as Qualified Intermediary for
(Exchanger)**

Pay to (Exchanger)
without recourse or
warranties of any kind whether express or implied

Accruit LLC as Qualified Intermediary for _____

By _____
Its: Managing Director

Assignment of Note Example

ASSIGNMENT OF NOTE

KNOW ALL MEN BY THESE PRESENTS:

That **Accruit, LLC, as Qualified Intermediary f/b/o (Exchanger)** (the “Assignor”) having an address at Old Orchard Towers South, 5250 Old Orchard, Suite 300, Skokie, IL 60077, in consideration of the sum of Ten Dollars and no/100 (\$10.00) and other good and valuable consideration, received from or on behalf of _____ (the “Assignee”), the receipt and sufficiency of which are hereby acknowledged, does hereby grant, bargain, sell, assign, transfer and set over unto the Assignee, its successors and assigns, its interest in the following:

- (a) Promissory Note, (the “Note”), dated as of October 31st, 2023, in the original principal sum of **\$2,881,300.00**, executed by _____ (“Borrower”).
- (b) Any and all interest of Borrower under any Collateral Agreement securing said Note.

TOGETHER WITH the monies due and to become due thereunder.

TO HAVE AND TO HOLD the same unto the Assignee, its successors and assigns, forever.

This Assignment is made without recourse or warranty (express, implied or statutory) to Assignor, except that Assignor warrants as follows:

1. Assignor is the legal holder and owner of the Note free and clear of any claims, liens or judgments.
2. Assignor has good right, power and authority to assign the Note and the undersigned is fully authorized to execute this instrument on behalf of the Assignor; Assignor has not executed any prior assignment or pledge of any Collateral Agreement.
3. The outstanding principal balance under the Note as of this date is **\$2,881,300.00**.

IN WITNESS WHEREOF, the Assignor has caused these presents to be executed in its name and its seal to be affixed, by its proper officer thereunto duly authorized, this **21st day of February, 2023**.

Accruit, LLC, as Qualified Intermediary f/b/o _____

By: _____
Martin S. Edwards, Managing Director

Seller Financing in Purchase of Replacement Property

- All Exchangers must replace Relinquished Property debt in an exchange with equal or greater Replacement Property debt (or new cash) to avoid mortgage boot
- Whether that new debt takes the form of a seller note or some type of installment agreement financing with the seller does constitute offsetting debt for this purpose

Financing Issues When Bank Lender Involved

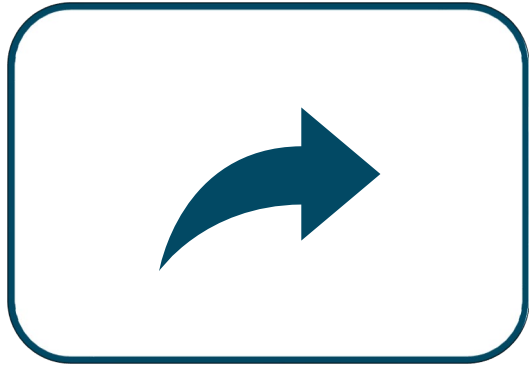
- In a **Forward Exchange**, the most common issue is that the Exchanger/lender tend to think about a loan for the maximum LTV, i.e. 75%
- Whereas in an exchange context they should be thinking how much debt will be needed given that the Exchanger needs to roll over all net equity, i.e. Exchanger's down payment should be at least as much as the amount of exchange proceeds

Financing Issues in Reverse Exchanges

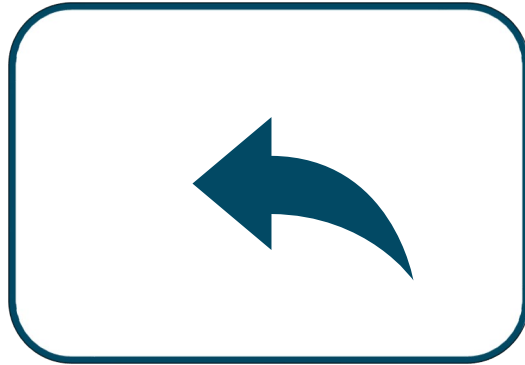
- In a **Reverse Exchange**, the most common problem is that the Exchanger makes the initial call to the exchange company and already has the financing for the replacement property “all worked out”
- Invariably that means that the loan will be made by FannieMae which, in turn, means it has to originate in the Exchanger’s name
- For Reverse Exchange purpose, title and loan have to be in the name of a new LLC owned by the Accommodator (the exchange company) and therefore is incompatible with a FannieMae type loan
- Must get a loan that is going to be kept in house by the bank

QUESTIONS?

Types of Parking Exchanges



Safe Harbor
Replacement Property
Parking Reverse
Exchange



Safe Harbor
Relinquished Property
Reverse Exchange



Safe Harbor Build-to-
Suit/Improvement
Property Exchange



"Non-Safe" Harbor
Transactions
Traditional/Bartell

Mechanics of Typical Reverse Exchange

- First step is to set up and assign purchase contract to a SM LLC owned by Exchange Accommodation Titleholder (“EAT”)
- Financing has to be provided to EAT from Exchanger and/or outside lender (lender will need all applicable org docs); TP can guaranty bank loan
- EAT will execute note to TP for loan and secure it with pledge of membership interest in LLC
- LLC will Master Lease property back to TP to allow management of property, collect all rent and pay all expenses
- Within 180 days, RQ property sells via forward 1031 exchange and parked property is acquired as the replacement property; proceeds flow through the EAT as seller and are used to repay TP acquisition financing in full and to lender to extent of available funds
- If possible, based on IRS rules, preference is to assign the membership interest to the Exchanger to transfer the parked property; otherwise, the property is transferred by deed

Mechanics of Relinquished Property Reverse Exchange

- Some special circumstances might cause the to consider triggering sale of Relinquished Property (RQ) by sale to EAT prior to closing date of purchase of Replacement Property (RP):
 - Exchanger's buyer of RQ property got delayed or denied
 - Exchanger arranged financing for the RP property that will not allow for an LLC
- Determine the net "purchase price" based on expected sale price to a BFP less closing costs and debt (the EAT is taking title subject to the existing debt)
- Standard reverse exchange documents are entered into including a note for the loan
- Exchanger lends the necessary funds and wires them to the EAT account
- As "buyer" the EAT places the funds into the TP's forward exchange account with the QI
- The conventional forward documents are entered into and the funds are applied by the QI to acquire the replacement property
- Within 180 days, the RQ property is sold by the EAT (as approved by TP) to a BFP and the proceeds are used to pay any underlying bank debt off in full and all remaining proceeds are used to repay all funds lent by TP

Mechanics of Build-to-Suit/Property Improvement Exchange

- A Build-to-Suit/Improvement Exchange is simply a variation on a reverse replacement exchange where while holding title to the property, improvements to the property are taking place to enhance to value to the property
- First step is to set up and assign purchase contract to a SM LLC owned by Exchange Accommodation Titleholder (“EAT”)
- Parties enter into IRS approved BTS/Property Improvement safe harbor documents
- EAT via LLC takes title to property and makes improvements per direction and supervision of Exchanger using exchange funds or borrowed funds
- Combined value of land and improvements in place by day 180 from sale of RQ property transferred to Exchanger via assignment of membership interest or deed
- If the underlying land originally owned by a related party, may be an option to just to an exchange for value of improvements by creating a long-term lease on the land to improve upon

Non-Safe Harbor Parking Exchanges

Rev. Proc. 2000–37

SECTION 3. SCOPE

.02 No inference . . .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..

Traditional Non-Safe Harbor Reverse Exchange

- Any favorable case law suggested that the Accommodator needed benefits and burdens of ownership
 - Economic risk should the property increase or decrease in value over the holding period
 - The Accommodator had to have some “skin in the game”; 5% of the total equity was typical
 - Exchanger could not guaranty the bank loan
 - Retention of rental income
 - Indemnifications of Accommodator
 - Agency relationship

Bartell Style Non-Safe Harbor Reverse Exchange

Estate of George H. Bartell, Jr. v. Commissioner, 147 T.C. No. 5 (2016)

Fall 2016: The decision in the Bartell case was handed down from the Ninth Circuit District Tax Court. The Court held in favor of the Exchanger and noted the following:

- Exchanger retained the benefits and burdens of ownership
- Exchanger was entitled to appreciation over the exchange period
- Exchanger held risk of loss in the event of a downturn
- Exchanger lent funds to the accommodator
- Exchanger financed and directed construction

Bartell Con't

- Exchanger had possession of the property under a lease
- Parking arrangement provided for 24 months
- The Court concluded that the third party (the accommodator) did not have to have the burdens and benefits of property ownership
- Court noted Ninth Circuit Court of Appeals too had held that burdens and benefits of ownership were not necessary in this context
- Court noted in all of the prior favorable rulings a third party the accommodator held ownership of the property during the transaction
- The IRS chose not to appeal the decision, IRS files a non-acquiescence

QUESTIONS?

Martin S. Edwards, JD, CES®
(312) 207-1031
martine@accruit.com

Matthew Douglas, JD
(773) 596-8228
matt@d@accruit.com