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GENERAL CONCEPTS OF 1031 EXCHANGES

Presented on behalf of ATG

ATTORNEYS' TITLE GUARANTY FUND, INC.

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IRC Section 1031

- "No gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind which is to be held either for productive use in a trade or business or for investment."
- The goal is "nonrecognition" of gain and to achieve total or partial *deferral* of gain (contrast with *exclusion* of gain)
- The rationale is that there is merely a continuity of investment

General Requirements

- Exchange Requirement (Role of QI)
- 45-day identification/180-day exchange period
- Like-kind property
- Qualified Use/Holding Requirement
- Same taxpayer
- Exchange equal or up in value

Threshold Question: What is the Taxpayers Tax Liability?

- Sale price – net adjusted basis = taxable amount
- Depreciation recapture (25%)
- Long-term capital gain tax (15-20%)
- NIIT (3.8%)
- State capital gain tax?
- Illinois 4.95%

- Net adjusted basis:
  - Original purchase price +
  - Capital improvements –
  - Depreciation taken over period of ownership =
  - Net adjusted basis
- Mortgage debt/payoff NOT relevant

Calculating Tax Liability: Example

Residential property purchased for $500,000 in 2013, sold for $1,000,000 in 2023:

Starting basis: $500,000

Depreciation: $400,000 (value of bldg.)/27.5 years = $14,545.45 x 10 years = $145,454.55

Net adjusted basis: $500,000 - $145,454.55 = $354,545.45

Federal Capital Gain Tax: $1,000,000 - $500,000 = $500,000 x 23.8% = **$119,000**

Federal Depreciation Recapture Tax: $145,454.55 x 25% = **$36,363.64**

IL Capital Gain Tax = $500,000 x 4.95% = **$24,750**

TOTAL TAX LIABILITY = $180,113.64

Exchange Requirement

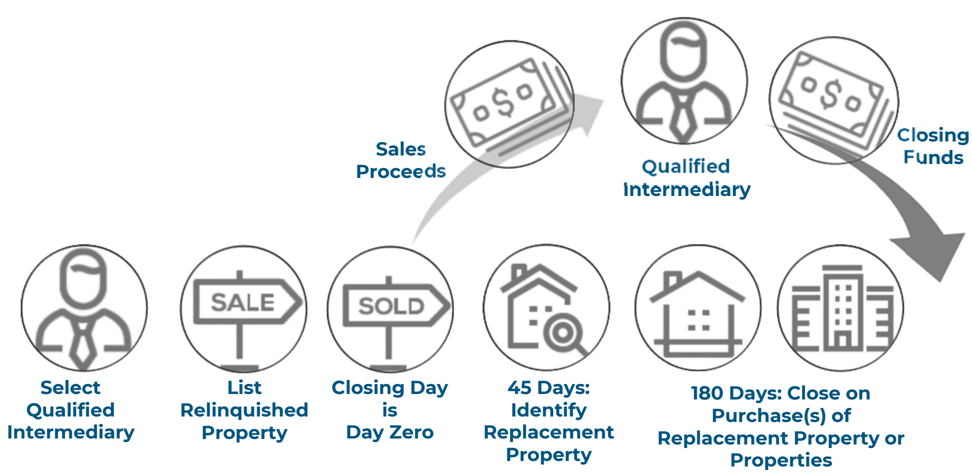
- Exchange means that the sale and purchase have to be mutually interdependent; requires reciprocal transfer of property (deemed satisfied where QI involved)
- How is this satisfied when TP sells to P1 and buys from P2 and isn't actually "exchanging" properties?
  - Answer: Qualified Intermediary fulfills role of exchanging with the TP

Qualified Intermediary

- QI required under applicable safe harbor to exchange under 1031, i.e. both RQ and RP transfer through QI
  - Cannot be "disqualified person"
- Rights to both relinquished and replacement property sale contracts assigned to QI to complete an "exchange" with QI (in practice, QI allows for "direct deeding" and does NOT go on title)
- QI receives sale proceeds – MUST avoid "actual or constructive receipt" by taxpayer
- Settlement statement should identify QI on behalf of the TP as seller and buyer

7

The Process

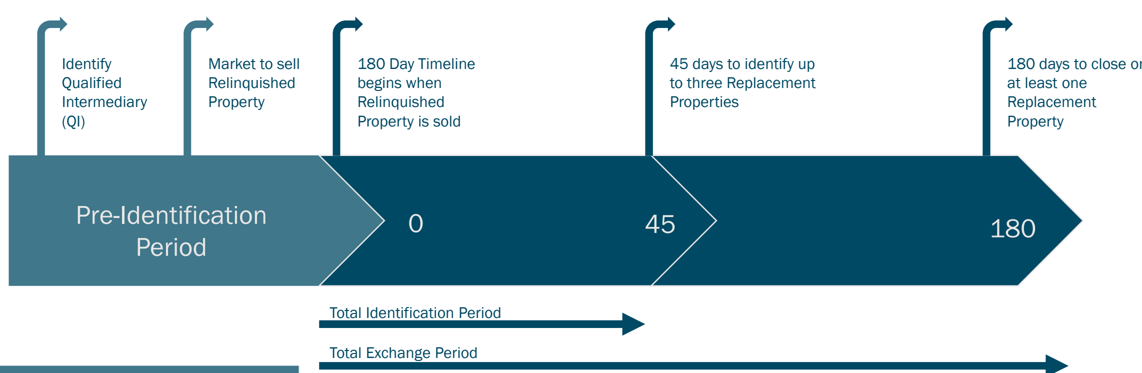


8

Exchange/QI: Common Scenarios and Pitfalls

- TP sells RQ without engaging a QI and later wants to do an exchange
  - Only option is recission of prior transfer, return to status quo ante
- TP buys new property with the intention of treating it as RP later when the RQ sells
- TP wants to use friendly party to avoid cost of exchange

Exchange Timeline



Identification Rules: Three Options

- **3 Property Rule** – up to 3 properties, without regard to FMV or RP properties;

  or

- **200% Rule** – any number of properties (more than 3), so long as aggregate FMV does not exceed 200% of FMV of relinquished properties;

  but

- **95% Exception** – if first two rules violated, must acquire 95% of FMV of all identified properties
  - Practically speaking, all identified RP properties

- Acquired RP must be "substantially the same as identified"

ID Rules: Common Scenarios and Pitfalls

- Only property ID'd falls through after 45-day period
- Incorrect address or property description identified within ID
- TP ID's too many properties and does not revise within 45-day period
- TP ID's entire property when actually acquiring a fractional interest (or vice versa)
  - Or ID's an amount outside the 75/25 regs example margin of error; common in identification of Delaware Statutory Trusts (DSTs)
- TP assumes going under contract on RP during 45-day period amounts to valid ID
  - Could be valid ID if stated as the buyer's ID in the contract; merely having an exchange cooperation clause is not enough

What Is Considered “Like-kind” Property?

- Generally, all real estate qualifies as like-kind to all other real estate
  - Tenant-in-common, Delaware Statutory Trust, IL-type land trust, 30+ year leasehold interests, water rights and more
- Only like-kind if held for use in trade or business or for investment
- Must be properly identified within 45 days to be considered like-kind
- Foreign property can be traded for foreign property but not considered like kind to U.S. property
- No more personal property exchange as of 1/1/18

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Qualified Use

- Business or investment
  - Holding bare land for appreciate = “held for investment”
- Holding period
  - No specific length of time; matter of TP intent
- No “dealer” property “held primarily for sale”
- Vacation homes or second homes do not qualify
- Changing title/liquidating entity before sale may disrupt qualified use

Qualified Use/Holding: Common Scenarios and Pitfalls

- TP has only owned RQ a short time
- TP uses RQ or intends to use RP for personal/family pursuits
  - See Rev. Proc. 2008-16
- TP rented RQ/RP to family member for less than market rent
- TP developed property and never held for investment (even if development takes several years)
- TP changes the way title is held shortly before exchange
- TP puts debt on RQ in anticipation of an exchange

15

Same Taxpayer

- Taxpayer that owns relinquished property MUST be same tax entity that acquired replacement property
  - "Taxpayer" determined by tax return on which income/expenses/losses reported
  - TIN/EIN not determinative
- Owner/titleholder may not be "taxpayer" for 1031 purposes
  - Living trusts
  - Single-member LLCs
  - Illinois land trusts

16

Same Taxpayer: Common Scenarios and Pitfalls

- Adding spouse to RP title when not on RQ title
- TP mistaken about tax disregarded status of an entity (i.e. a SMLLC that has elected S-corp treatment, trust that becomes irrevocable)
- Title to RQ changes shortly before exchange
- LLC/partnership wishes to restructure, some partners to cash out and others to do exchange
  - “Drop and swap” technique—can be complicated and requires advance planning

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

Examples of Allowable Expenses and Closing Costs:

- Real Estate Broker's Commissions
- Qualified Intermediary fees
- Recording or Filing Fees
- Attorney & Tax Advisor Fees Related to the Acquisition
- Owner's Title Insurance Premiums
- Escrow or Settlement Agent Fees
- Finder Fees or Referral Fees-Documentary Transfer Taxes

Examples of Non-Allowable Expenses and Closing Costs:

- Financing Fees (loan fees, loan points, appraisal fees, mortgage insurance premiums, lender's title insurance policy premiums, and other loan processing fees)
- Property Taxes
- Prorated Rents
- Repairs and/or Maintenance Costs
- Insurance Premium Payments

Rent Prorations and Security Deposits

- In a non-exchange closing, custom is to credit buyer for prorated monthly rent and security deposits
- In a sale involving a taxpayer doing an exchange, this would unwittingly cause boot to the taxpayer
  - Practical effect is to allow the taxpayer to keep the rental income and security deposits in TP's pocket while lowering the net proceeds of the sale that taxpayer put into the exchange account
  - If nothing further is done, that constitutes boot by applying exchange funds to non-like kind real estate
  - **For sale of RQ in an exchange, taxpayer should pay the rent and security deposit direct to buyer where possible to avoid boot**

Additional Considerations

Refinancing proximate to exchange	• Must be supported by independent economic substance
Business restructuring proximate to exchange	• Plan ahead; possible adverse effects on holding and use requirements
Effect of seller financing on exchange	• If TP provides financing, will have to supply fresh cash in that amount into the exchange account
Related-party transactions	• Generally speaking, TP can't buy RP from a related party

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*

Basics of Reverse Exchanges

- Refers to acquisition of RP *before* sale of RQ
- "Reverse" term is a misnomer; a reverse exchange not a reverse exchange at all
- No "pure reverse" exchanges allowed
- Sometimes referred to as "parking transactions" since title to the property has to be held or "parked" with an Exchange Accommodation Titleholder ("EAT")
  - The entity acquiring title is typically a newly formed special-purpose LLC wholly owned by EAT
- Same parking-in-EAT structure also used for adding improvements to property
- Rev. Proc. 2000-37 and the "safe harbor"
- Regardless of type of parking deal, there will ALWAYS be a Qualified Intermediary in addition to an EAT; can be same company as EAT or different

What factors might lead to the need for a reverse exchange?

- Taxpayer might face losing the perfect replacement property
  - Relinquished property sale contingency not realistic
  - Attractive property with multiple bidders
- Taxpayer may not want to give up good property for something unknown
- Taxpayer may want to alleviate the pressure of the 45-day identification requirement
- Taxpayer may feel he/she has more control over the sale of the property than finding the right replacement property in a short time
- Buyer financing for purchase of relinquished property gets delayed or deal otherwise falls through
- Taxpayer can increase cash flow during exchange period

Reverse Exchanges: Common Scenarios and Pitfalls

- TP already bought RP in own name
- TP can't sell RQ within 180 days
- TP provided incorrect taxpayer at outset of reverse exchange (e.g., thought one spouse owned but both own)
- Two or more potential RQs owned by different TPs
- TP requires bank loan to fund purchase
  - Requires time to clear underwriting
- Reverse must be pulled together at last minute
- Transferring property to TP at end of exchange: assign LLC interest, or deed? Transfer tax? Title insurance issues?

Build-to-Suit & Property Improvement Exchanges

- For exchange purposes, building from ground up (B-t-S) or making additional improvements are treated the same way
- When the property purchase is funded by relinquished property sale proceeds it is referred to a Forward Build-to-Suit or Property Improvement Exchange
  - Subject to same 45-day ID and 180-day exchange periods as regular forward
- When the relinquished property is not yet sold and the replacement property purchase is funded by the TP or a bank, it is referred to as a Reverse Build-to-Suit or Property Improvement Exchange
  - Subject to 45-day ID of the RQ property and 180 days for improvements to be made (no requirement that the improvements be finished)
- For purpose of making improvements the property must be parked with the EAT so does not make a difference if it is reverse sequence transaction

Improvement Exchanges: Common Scenarios and Pitfalls

- Most common issue: TP can't complete necessary amount of work in 180-day period
- TP decides to do/learns of improvement exchange well into 180-day exchange period
- TP identified the property within 45-day period but not the intended improvements
- Multiple RQs: consecutive 180-day periods to spend respective values? (Very difficult)

QUESTIONS?

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