


Advanced Concepts in Section 1031 Exchanges



February 3, 2021

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ATG LEGAL EDUCATION Advanced Concepts in Section 1031 Exchanges 

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Advanced Concepts in Section 1031 Exchanges


February 3, 2021

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SHIFTING FROM FORWARD TO REVERSE: ADVANCED CONCEPTS IN SECTION 1031 EXCHANGES

ATG CLE COURSE

February 1, 2021

JORDAN BORN, J.D., LL.M.

ACCRUIT, LLC

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WHAT IS A 1031 EXCHANGE?



A tax deferral mechanism that defers tax on long term capital gains & transfers the adjusted basis from the Relinquished property to the Replacement property as provided for in Section 1031 of the IRC.

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Qualified Use
IRC Section 1031(a)(1)

“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.”

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GENERAL REQUIREMENTS



Qualified Use



Like-Kind



Exchange vs. Sale

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WHY PERFORM A 1031 EXCHANGE?

CAPITAL GAINS

Capital gains taxes & depreciation recapture are substantial

LEVERAGE FOR WEALTH BUILDING

Leverage dollars otherwise spent on taxes

REALLOCATE ASSETS

Transfer to income producing property

ESTATE PLANNING

Diversity and minimize risk during retirement while planning your estate

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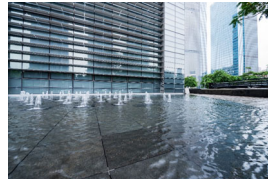
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WHAT IS CONSIDERED “LIKE-KIND” PROPERTY?

RAW LAND



COMMERCIAL



RESIDENTIAL



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WHAT IS CONSIDERED “LIKE-KIND” PROPERTY?

Other Examples, including but not limited to:

- Mineral rights (oil, gas)
- Water rights
- Cell Tower easements (perpetual best but long term may be OK)
- Billboard easements
- Leasehold interests (term over 30 yrs. w/options)
- Beneficial interest in land trusts (PLR 92-105)
- Co-ops Shares of a corp.
- Single member LLC interests holding title to property
- Property improvements (Whole section on this later)

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APPLICABLE TAXES

CAPITAL GAIN

Federal Tax 15-20% plus applicable
State Tax up to 13.3%

DEPRECIATION RECAPTURE

A 25% tax captured at the time of sale

NET INVESTMENT INCOME

A 3.8% tax for single filing, high earners

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How to Determine Taxable Gain

1st Calculation: Net Adjusted Basis

Original Purchase Price (Basis)	\$300,000
Add: Capital Improvements	+ 20,000
Less: Depreciation	- 100,000
Equals: Net Adjusted Basis	\$220,000

2nd Calculation: Capital Gain

Today's Sales Price	\$900,000
Less: Net Adjusted Basis	- 220,000
Less: Sales Expenses	- 80,000
Equals: Capital Gain	\$600,000

3rd Calculation: Tax Due

Recaptured Depreciation ($\$100,000 \times 25\%$)	\$ 25,000
Federal & State Capital Gain ($\$600,000 \times 27\%^*$)	\$162,000
Net Investment Income Tax SF/HE ($\$600,000 \times 3.8\%$)	\$ 22,800
Total Tax Due	\$ 209,800

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WHO CAN DO A 1031 EXCHANGE?

Any qualified taxpayer, either an individual or a business entity whose legal title remains the same on both legs of the transaction.

Exchange follows the taxpayer, SSN or EIN



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DISREGARDED ENTITY

For income tax purposes, the IRS treats the entity as being non-existent and the tax consequences of that entity are reported on the individual income tax return of the person who owns the entity.



EXCEPTION

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PURCHASE OR SALE CONTRACT

Sample
Exchange
Cooperation
Clause

“Each of the parties hereto may assign its rights (but not its obligations) under this Agreement to a qualified intermediary as defined in (and as part of a tax-deferred like-kind exchange under) Internal Revenue Code Section 1031 and the Treasury Regulations thereunder. Said exchange will be closed without cost, liability or delay to the non-exchanging party.”

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ALLOWABLE EXPENSES

- Brokerage Commissions
- Inspecting & Testing Fees
- Escrow & Notary Fees
- Recording Fees
- Document Transfer Fees
- Title Insurance Premiums
- Tax Service & Legal Consultation Fees (that pertain exclusively to the exchange transaction)
- Exchange/ Accommodator Fees



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UNALLOWABLE EXPENSES



- Rent
- Utilities
- Property Taxes
- Property Insurance
- Association Dues/ Assessments
- Repairs and Maintenance
- Loan Acquisition Fees

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PROS

Defer long term Capital Gains taxes & depreciation recapture, estate planning, buy up and/or acquire multiple properties.



CONS

Basis carries over, must purchase real property, funds held by QI become illiquid during the exchange



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Maximize 1031 Exchange



REINVEST

Reinvest all net proceeds from relinquished property sale into replacement property

PURCHASE

Purchase replacement property of equal or greater value to relinquished property

FINANCE

Obtain equal or greater financing on replacement property as was paid off on relinquished property *

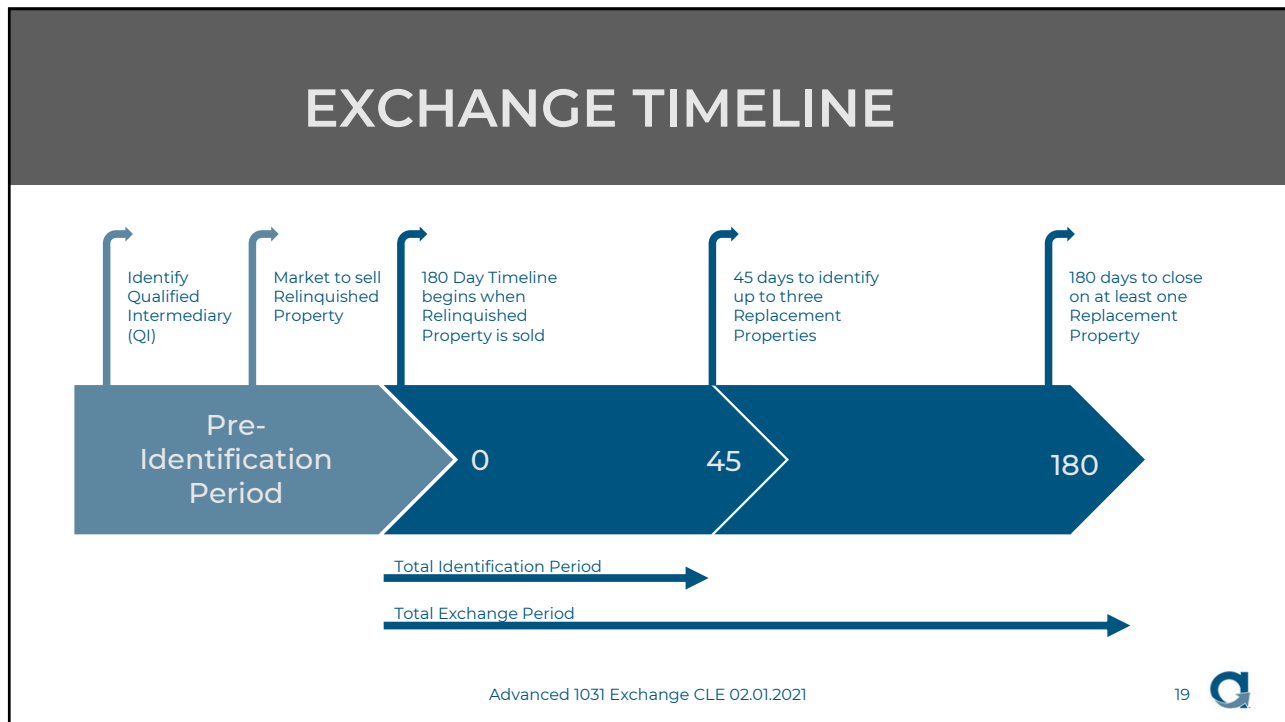
if applicable*

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RULES OF IDENTIFICATION

- | | |
|--|---|
| 1. | 2. |
| Identifications must be made in writing | Received (electronically) by midnight on the 45 th day |
| 3. | 4. |
| Must be dated and signed by the taxpayer(s) involved | Describe unambiguously the property (physical or legal) |

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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

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WHAT IS PARKING?

“Parking” is when an exchange company (“EAT”) goes on title for the relinquished or replacement property.

This process is complex but necessary in order to do a reverse OR improvement exchange under the safe harbor of IRS Rev. Proc. 2000-37.



BUY BEFORE YOU SELL

To avoid taxpayers taking title to property prior to the sale of the relinquished property, the regulations suggest parking the title with an EAT to hold until the relinquished property is sold.

Once the old property is sold, the new property is turned over to the taxpayer.



IMPROVEMENT EXCHANGES

Build for the future

An exchange in which the exchanger desires to build-upon or make improvements to the replacement property with their 1031 Exchange funds.

Taxpayer gets credit for the land and improvements value.



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Reverse Exchanges: The Basics & Beyond

- Introduction to Reverse Exchanges
 - Term is a misnomer; Why is a reverse exchange not a reverse exchange at all?
 - What is a pure reverse exchange?
 - Safe harbor vs. non-safe harbor reverse exchanges
 - Reverse exchange procedures also used for adding improvements to property
 - Sometimes referred to as “parking transactions” since title to the property has to be held or “parked” with an accommodating party

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Reverse Exchanges: The Basics & Beyond

“Treasury and the Service have determined that it is in the best interest of sound tax administration to provide taxpayers with a workable means of qualifying their transactions under § 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 and actually accomplishes the exchange within a short time thereafter. Accordingly, this revenue procedure provides a safe harbor that allows a taxpayer to treat the accommodation party as the owner of the property for federal income tax purposes, thereby enabling the taxpayer to accomplish a qualifying like-kind exchange.”

IRS Rev. Proc. 2000-37

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Reverse Exchanges: The Basics & Beyond

Exchange Last / Parking the Replacement Property:

To avoid the taxpayer taking title to property prior to the sale of the RQ property, regulations suggest “parking” the title with an exchange company (“EAT”) to hold until the RQ property is sold. Once the old property is sold the new property is turned over to the TP.

Exchange First / Parking the 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 (EAT) to trigger a sale prior to the purchase of the RP property.

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Reverse Exchanges: The Basics & Beyond

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

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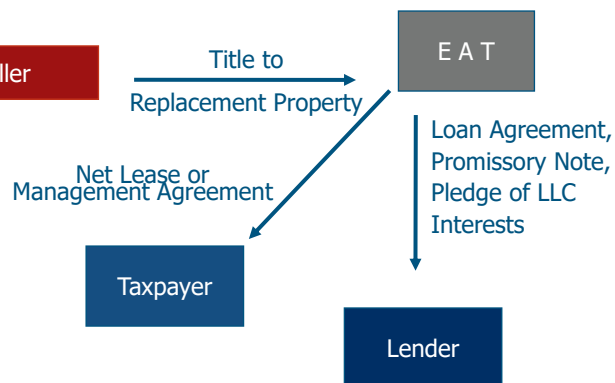
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Reverse Exchanges: The Basics and Beyond

Exchange Last Transactions – Steps

(Replacement Property Parking)

- Financing is provided by Taxpayer directly, by a third party Lender, or a combination of both
- Operation, control and economic benefit of the property is transferred to the Taxpayer via a net lease or management agreement
- EAT takes title to the replacement property



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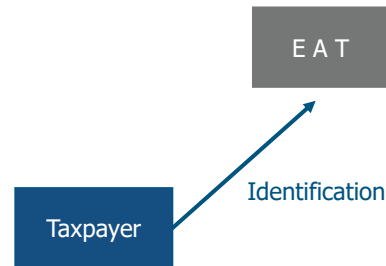


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Reverse Exchanges: The Basics and Beyond

Exchange Last Transactions – Steps

- Taxpayer formally identifies property that will be relinquished within 45 days from the date the EAT acquires the parked Replacement Property
- The Identification notice is a written document that is signed by the Taxpayer and delivered to the EAT prior to the end of the Identification period



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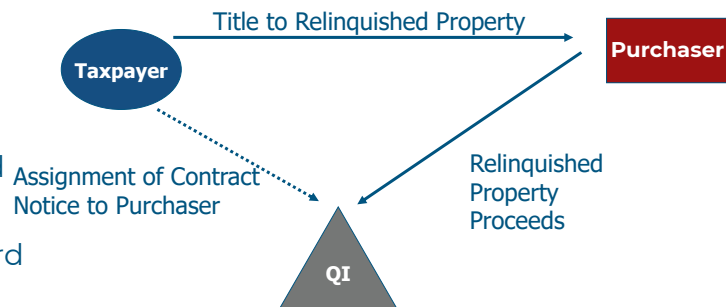


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Reverse Exchanges: The Basics and Beyond

Exchange Last Transactions – Steps

- Relinquished Property is sold to a third-party buyer
- Taxpayer enters into a forward exchange with a QI
- Sale Proceeds are deposited with the QI



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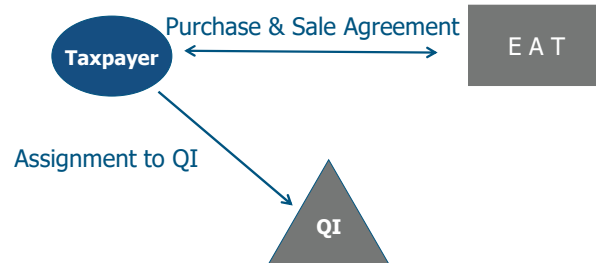


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Reverse Exchanges: The Basics and Beyond

Exchange Last Transactions – Steps

- Taxpayer instructs QI to acquire the parked Replacement Property from the EAT
- Taxpayer and EAT have executed a Purchase & Sale Agreement which might be the QEAA itself
- Taxpayer assigns its rights under the PSA to the QI just like any forward exchange



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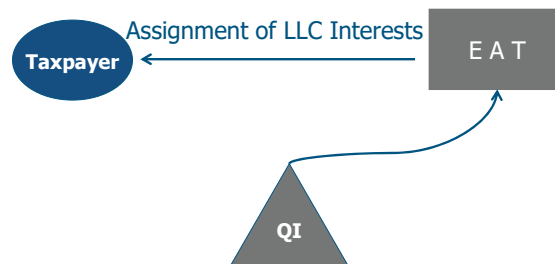


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Reverse Exchanges: The Basics and Beyond

Exchange Last Transactions – Steps

- EAT assigns the LLC interests in the Titleholder to the Taxpayer (or transfers the property by deed)
- QI to pay proceeds to EAT as "Seller" and EAT reimburses Taxpayer for advanced funds
- Any additional proceeds are used to pay off or pay down conventional financing



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Reverse Exchanges: The Basics & Beyond

Documenting the Reverse Exchange of Replacement Property:

- Qualified Exchange Accommodation Agreement
- Non-Recourse Promissory Note
- Pledge Agreement of Membership Interest (Deed of Trust or Mortgage)
- Master Lease
- Assignment of Real Estate Purchase Contract
- Environmental Indemnity Agreement (Phase 1 Environmental Audit)
- Operating Agreement for SPE LLC
- Obtaining Tax Identification Number
- Organizing the LLC
- Insurance in name of LLC
- Assignment of Membership Interest or issuance of Deed

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Reverse Exchanges: The Basics & Beyond

Parking Replacement Property

Qualified Exchange Accommodation Agreement:

- Recitation of intent to enter into a reverse exchange arrangement and general terms as required by the Rev. Proc.
- Taxpayer name and contact information
- Identification of the applicable relinquished and replacement properties
- Reference to the Qualified Intermediary associated with the transaction
- Reverse exchange fee
- Signatures

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Reverse Exchanges: The Basics & Beyond

Non-Recourse Promissory Note

- This would be for portion TP is financing (including earnest money put down)
- Generally amount can be taken from the Buyer's Settlement Statement
- Can provide to cover additional future advances by the TP
- To be signed only by the LLC acting as, or on behalf of, the EAT
- Not typically interest bearing
- Reference to the security for the Note (Pledge, Deed of Trust, Mortgage, etc.)
- Non-recourse

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Reverse Exchanges: The Basics & Beyond

Pledge of the Membership Interest

- Can be given to the TP to secure the TP loan to the EAT Titleholder LLC
- Less strong than a recorded lien interest but reasonable for purpose intended
- Easy to put in place and remove; no recordings need to be done
- No UCC filing necessary

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Reverse Exchanges: The Basics & Beyond

Bank lender financing

Bank will require all or some of the following:

- Operating Agreement for SPE LLC
- Articles of Organization for LLC
- Evidence of Good Standing for Borrower LLC
- Operating Agreement and Org Docs for EAT
- Operating Agreement and Org Docs for Parent company of the EAT
- May want personal information for owners of parent company
- Signing resolutions for LLC and EAT
- Specific borrowing resolution
- Taxpayer guaranty

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Reverse Exchanges: The Basics & Beyond

Master Lease

- Shifts management, taxes, utilities, maintenance, rent collection, etc. to TP
- Often the lease will provide as rent that the TP will pay any interest due on any loan from a bank lender to the EAT
- Standard lease contains environmental indemnities from TP
- Some EATs use Property Management Agreement in lieu of Master Lease

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Reverse Exchanges: The Basics & Beyond

Assignment of Real Estate Contract

- Assignment transfers rights to EAT to acquire the property per the contract executed prior by TP
- Allows the EAT to stand in the shoes of the TP as purchaser
- Need to make sure that the contract does not have prohibition against assignment
- General legal rule that if not explicitly prohibited then assignable
- May want to incorporate a consent to the form for seller to execute
- THIS IS NOT covered by the “exchange cooperation clause” often found in form contracts
- DO NOT confuse this assignment with the assignment of rights to the QI

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Reverse Exchanges: The Basics & Beyond

Environmental Indemnity Agreement

- LLC has no assets other than the property so liability is already limited
- Some reverse exchange accommodators will require a Phase One environmental audit
- EAT LLC is not legally entitled to rely on Phase One findings if the LLC is not named in the report as one of the parties for whom it was prepared
- Side “Reliance Letter” from party providing the audit will allow EAT LLC to be covered
- If EAT and Titleholder LLC are not the same party, may want to have them both separately indemnified
- Term of indemnification should survive the period of the transaction

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Reverse Exchanges: The Basics & Beyond

Operating Agreement

- Every LLC requires an Operating Agreement to govern its affairs
- Sets forth name; date and state of organization; state file number and type of management, i.e. member or manager managed
- Typically the EAT is the member and manager
- Possible for the TP or designee to be named manager
 - This can facilitate loan document execution
 - Sometimes gives comfort to the client and/or lender
- Possible for manager to make the TP or designee an authorized signer

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Reverse Exchanges: The Basics & Beyond

Organizing the LLC

- Can be done by the EAT, the client or the client's attorney or an outside vendor
- Have to determine what State is the best option based upon the facts of the transaction
- Have to stay on top upon conclusion of the transaction with changing the manager, member, registered agent or dissolving the LLC
- Costs associated with forming the LLC include some or all of the following: Filing fees, foreign qualification; corporate registered agent; annual LLC fees and dissolution fees

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Reverse Exchanges: The Basics & Beyond

Obtaining a Taxpayer Identification Number

- Not legally required, as disregarded entity can use EAT's number
- Go to the IRS.gov web: <https://sa.www4.irs.gov/modiein/individual/index.jsp> and "Begin Application"

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Reverse Exchanges: The Basics & Beyond

Assignment of Membership Interest

- Transfers effective ownership of the property back to the TP
- Ownership transfer can be done via deed if desired by the TP
- If done by deed a "hold open" title policy should be arranged
- Loan documents and other documents do not have to be changed
- May allow favorable treatment for transfer tax purposes
- Make sure client or counsel follows up with noting applicable changes with the Secretary of State e.g. change of manager; registered agent

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Reverse Exchanges: The Basics & Beyond

Transfer Tax Considerations

- If conveyed to TP by deed generally need to provide information on “consideration”
- Taking position that the EAT is only the agent of the TP can help support no actual consideration (See IRS PLR 200148042)
- If conveyed by assignment of membership interest most local and state transfer tax ordinances only cover conveyances by deed
- Some transfer tax ordinances cover any effective transfer of real estate even if part a sale of stock, sale of a partnership, etc.
- Some jurisdictions have express written rulings for the exemption
- Some states assess a tax even if there is no actual consideration

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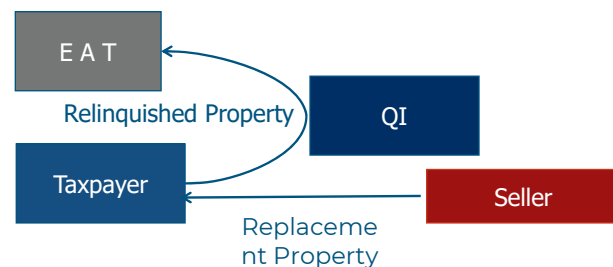


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Reverse Exchanges: The Basics and Beyond

Exchange First Transactions – Steps (Parking the Relinquished Property)

- Taxpayer enters into an Exchange Agreement with a Qualified Intermediary and a Qualified Exchange Accommodation Agreement with the EAT
- The EAT buys and takes title to the Relinquished Property
- Normal forward exchange through QI takes place with EAT as the buyer
- Taxpayer buys the Replacement Property through normal forward exchange process



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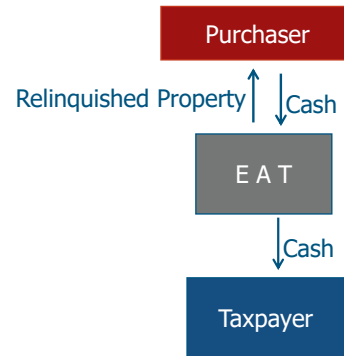


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Reverse Exchanges: The Basics and Beyond

Exchange First Transactions – Steps

- Within 180 days the EAT transfers the Relinquished Property to the Third Party Purchaser
- Sale proceeds are used to reimburse the Taxpayer or other funding source for funds lent to the EAT
- Any underlying bank loan is paid off



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Reverse Exchanges: The Basics & Beyond

Documenting the Reverse Exchange of Relinquished Property:

- Qualified Exchange Accommodation Agreement
- Relinquished Property Acquisition Contract
- Non-Recourse Promissory Note
- Pledge of Membership Interest
- Master Lease
- Environmental Indemnity Agreement
- Insurance in name of LLC
- Operating Agreement
- Obtaining an Tax Identification Number
- Conveyance by Deed to Buyer

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Reverse Exchanges: The Basics & Beyond

Determining Relinquished or Replacement Property to Park for Reverse Exchange

- What are the respective values, e.g. \$500k RQ property and \$10M RP property
- Difficult to estimate the value of the relinquished property
- May need to “true up” relinquished property sale value after sale to 3rd party
- Only “equity” portion of the RQ property needs to be covered
- May effect due on transfer clause in underlying RQ property loan
- Special financing requiring TP be in direct ownership, e.g. TIF, Enterprise Zone, etc.
- Are there environmental issues associated with either property
- Transfer tax considerations

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Reverse Exchanges: The Basics & Beyond

Build-to-Suit & Property Improvement Exchanges

Treasury Regulations §1.1031(k)-1(e)(4):

The transfer of relinquished property is not within the provisions of section 1031 (a) if the relinquished property is transferred in exchange for services (including production services). Thus, any additional production occurring with respect to the replacement property after the property is received by the taxpayer will not be treated as the receipt of property of a like kind.

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Reverse Exchanges: The Basics & Beyond

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 Build-to-Suit or Property Improvement Exchange
- 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
- 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

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Reverse Exchanges: The Basics & Beyond

Build-to-Suit & Property Improvement Exchanges

- TP may loan necessary funds and/or guaranty a bank loan
- TP may supervise the improvements, approve draw requests, and act as the general contractor
- At the earlier of the time the improvements are finished or 180 days from the inception of the forward or reverse exchange, the property is transferred back to the taxpayer

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Reverse Exchanges: The Basics & Beyond

Build-to-Suit & Property Improvement Exchanges

- Need to describe the land and the intended improvements in as much detail as practical
- If the property at the end of the improvement period conforms to the identification but is less than complete the transaction is still valid
- May wish to incorporate plans and drawings or agreement with the contractor and incorporate by reference

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Reverse Exchanges: The Basics & Beyond

Build-to-Suit & Property Improvement Exchanges

- Taxpayer gets credit for the land and improvements value
- Improvements do not need to be completed at the time the property is turned over to the taxpayer
- Cannot prepay contractor or simply have materials delivered to the job site
- Cannot build or improve property already owned by TP or from a related party.

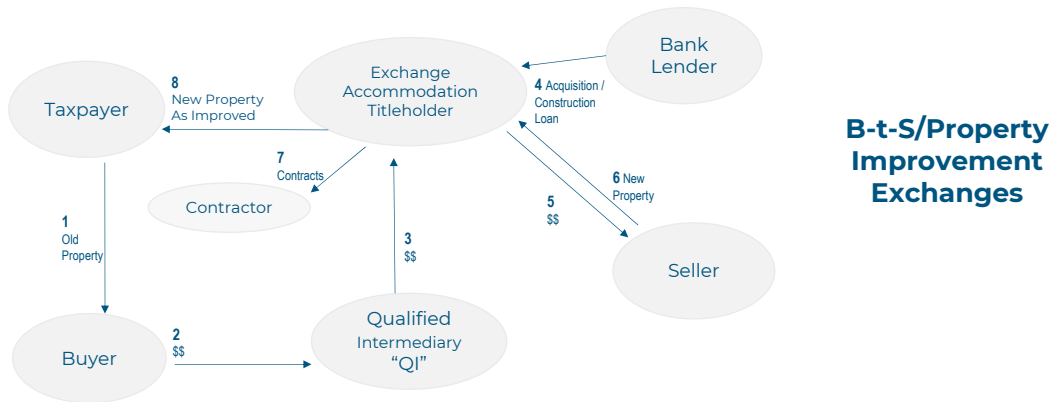
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Reverse Exchanges: The Basics & Beyond



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Reverse Exchanges: The Basics & Beyond

Documenting the B-t-S or Property Improvement Exchange:

- Qualified Exchange Accommodation Agreement
- Build-to-Suit / Property Improvement Limited Liability Sale Agreement
- Assignment of Real Estate Purchase Contract
- Environmental Indemnity Agreement
- Construction Management Agreement
- Draw Request and Approval
- Operating Agreement
- Obtaining Tax Identification Number
- Assignment of Membership Interest
- Insurance in name of LLC, including Builder's Risk coverage
- Note, Pledge and Master Lease not usually needed

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Reverse Exchanges: The Basics & Beyond

B-t-S and Property Improvement Exchanges:

Construction Management Agreement

- Takes project management away from EAT and puts it on TP or designee
- Can include compensation for manager but generally does not
- Joinder added for TP to sign the Agreement if the TP is not the manager

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Reverse Exchanges: The Basics & Beyond

B-t-S and Property Improvement Exchanges

Draw Request and Approval

- Requires sender name, property address, number of the draw request, etc.
- Client to put in name and address of payee; description of materials/labor, amount
- Client enters draw amount, prior draw subtotal and cumulative total
- Recitation included that construction manager will or has obtained lien waivers

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Reverse Exchanges: The Basics & Beyond

Tax Reporting for Parking Transactions

- Both parties must report consistently on their tax returns
- Real estate taxes and interest on loan payments usually shifted to TP which converts them to rental expense to TP and rental income to EAT
- Any principal payment on bank loan is usually deemed as a loan of that amount from TP and added to the principal amount of any loan from TP to EAT
- TP cannot take depreciation nor does the EAT since holding as inventory for sale
- May not file actual return if part of a consolidated return for the company
- May be necessary in some states to file returns (like California)
- Consult on tax preparation and filing with client's professional advisors, attorney & CPA

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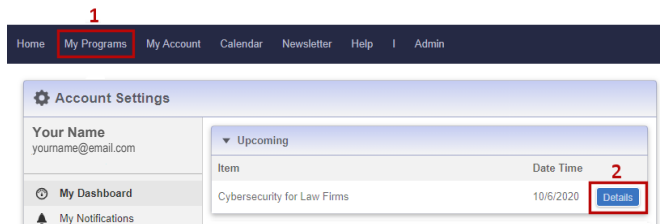
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