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Emerging Trends of 1031 Exchanges

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Speaker Introductions

- **Brian K. Humes, CPA**

  Brian is a tax principal in CLA's construction and real estate group. He has more than 25 years of experience with commercial real estate transactions, TDD and CID incentives, real estate tax abatements, and like-kind exchanges. Brian also has extensive experience consulting clients with new market tax credits.

- **Robert J. Nowak, Jr., CPA, MST**

  Rob is a principal in CLA's construction and real estate group and has 20 years of experience assisting contractors and real estate entities with tax compliance, IRS dispute resolution, tax mitigation strategies, transaction planning, and other industry consulting issues. He also specializes in long-term contracts, deferred exchanges, real estate investment trusts, partnership taxation, domestic production activities deduction, cost segregation and energy efficient design, as well as construction incentives.

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Learning Objectives

At the end of this session, you will be able to identify:

- ✓ The fundamentals of a 1031 exchange
- ✓ Current problems in exchanges and emerging trends in partnership split ups, split offs, co-ownership, and Delaware Statutory Trusts
- ✓ Recent trends in reverse and built-to-suit exchanges
- ✓ Tax treatment of debt on relinquished and replacement properties
- ✓ State tax implications related to like-kind exchange

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Section 1031 Fundamentals

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- Section 1031 (a) (1) provides:

  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.

Section 1031 Fundamentals

- Property EXCLUDED from nonrecognition under 1031
  1. A partnership interest
  2. Stock in trade or property held primarily for sale
  3. Stock/securities/bonds

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Section 1031 Fundamentals – Holding Period

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- Can a taxpayer buy a largely vacant retail center, obtain a large tenant a month later, and sell the property within months of acquisition followed by a Section 1031 exchange?
    1. There is no required holding period for either the relinquished property or replacement property
    2. The purpose of buying the asset (was it held primarily for sale?)
- Same issue if the replacement property is sold shortly after its purchase

Section 1031 – Like-Kind Requirement

- The relinquished and replacement properties must be of like-kind
- The regulations indicate this requirement relates to the nature or character of the property, not to its grade or quality
- In real estate, this results in improved and unimproved real estate being of like-kind
- Real estate outside the U.S. is not of like-kind to real estate in the U.S.

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Section 1031 Like-Kind Requirement

- Taxpayer sells investment land for $3MM and wishes to buy land for $1MM and make $2MM of improvements on the land. Will the improvements be of like-kind?
    1. The taxpayer cannot acquire the land then make the improvements. - Bloomington Coca Cola case
    2. A party not acting as the taxpayer's agent should make the improvements before the taxpayer receives the $3MM property as replacement property

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Deferred Exchanges Under Section 1031

- Under Section 1031 (a)(3) replacement property must be identified and acquired within prescribed time periods
  - Identify on or before the day which is 45 days after the date on which the transfer of the relinquished property, and
  - Acquired within 180 days after the date of transfer of the relinquished property, or *the due date of the taxpayers' tax return (including extensions)*

Deferred Exchanges – Continued

- It is necessary to use a qualified intermediary – merely holding proceeds from the sale of relinquished property in an escrow account or acquiring replacement property within 180 days does not provide the deferral of gain recognition under Section 1031
- A taxpayer cannot have constructive receipt of the exchange funds upon sale of the relinquished property

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Deferred Exchanges – Identification

- Identification must be written and unambiguously described
- If you intend to buy an undivided interest in a property, we suggest the identification to be specific to such percentage interest (a dollar amount may be specific)
- A legal description is preferred
- Three properties can be identified regardless of their FMV, or any number of properties so long as their aggregated FMV does not exceed 200% of relinquished properties

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Deferred Exchange – Identification Issues

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- A taxpayer can identify improvements to be made on the replacement property
- Construction is not required to be complete if the property is real property improvements.
- Prepaying the contractor does not increase the replacement property value—you use only the % completed in determining the value of the replacement property received on the 180th day
- These 'build to suit exchanges' take great care to accomplish under Section 1031

Qualified Intermediaries

- Regulation Sec 1031 (g)(4) provides a safe harbor use of a QI who will not be viewed as the taxpayers' agent
- The taxpayers' right to the exchange funds are limited preventing constructive receipt
- The QI cannot be the taxpayer or a disqualified person and there must be a written agreement between the QI and taxpayer

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Reverse Exchanges

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- You can buy what you want before you sell what you have and still use Section 1031—often referred to as "parking arrangements"
  - There are safe harbor and non safe harbor reverse exchanges (safe harbor under Rev Proc 2000-37)
  - Under the safe harbor, the exchange accommodation titleholder "EAT" can acquire the replacement or relinquished property and hold the asset for up to 180 days

Reverse Exchanges

- The Taxpayer and the EAT must (within 5 days of the EAT owning the property) enter into a written agreement and the EAT is treated as the beneficial owner of the real estate during the time it holds title
- Assuming the EAT owns the replacement property, now the taxpayer must identify (45 days) the relinquished property that will be sold and exchanged with the EAT's property

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Reverse Exchanges Not Under Safe Harbor

- The structure must change under a non safe harbor reverse since the EAT is clearly an agent for all purposes except federal income tax under Rev Proc 2000-37. The agency cannot exist once outside the safe harbor
  - Decide whether you are going safe harbor or not at inception since the structure will change
  - The EAT should have benefits and burdens and make an investment that is subjected to some risk

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Partnership Split Up Models

Facts: A (A gifted 5% to his son A1 four years ago) & B have each owned 50% of their manufacturing Company facility for 30 years. They also owned the manufacturing Company in another entity and sold the assets of the manufacturing company (not the real estate) two years ago with a two year lease of the facility. They also own 10 acres surrounding the plant. The real estate is owned in an LLC taxed as a partnership. The real estate and land have a basis of $500k and due to the surrounding land, has a FMV of $7.5 million.

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Partnership Split – Drop To Co-Tenancy

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- B wants cash and is therefore willing to pay tax while A & A1 would prefer a Section 1031 to defer tax
- If a 50% interest is deeded to B, since B is not exchanging, how long B holds the interest is not an issue
- The existing LLC retains its 50% interest and a closing, uses a QI to begin a deferred exchange. The LLC is thereafter owned 90% by A and 10% by A1

Partnership Drop and Swap

- Now Assume that B's accountant explained to B that she would owe over $900K in federal and state taxes, so B is considering a triple net lease asset as an option
- A & A1 have their eyes on a troubled retail center that A1 will fix up and lease which is at the other end of the risk profile and B wants no part of that concept
- Now the LLC will deed 50% to B and 50% to a new LLC created by A & A1 setting up the option for each group to have their respective exchange options

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Partnership Drop and Swap – Issues to Consider

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1. Purpose in holding the dropped property-was it held for sale?
2. How long before the sale of the facility should the drop occur? Would it have been better to drop 2 years ago when they sold and leased back the facility to buyer of the manufacturing Company?
3. Our facts had no debt on the real estate, would a lender have approved the drop and how would debt change the structure?

Partnership Split Up – Swap and Drop

- Using the same facts, what if the drop first was considered too risky due to some LOI's that had been exchanged with a developer that wanted the property
- Have the LLC sell the facility and land and use a QI for the entire sale proceeds
- The LLC then identifies the NNN lease asset and the retail center within 45 days and buys both assets within 180 days
- After waiting ___ months, the NNN asset is dist. to B

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Partnership Split Up – Continued

- When some gain occurs inside the partnership (maybe due to one partner requesting cash from the transaction), can the partnership specially allocate the gain to the partner (or partners) that desire cash?
- Could five acres of land in slide 15 be conveyed by the LLC to the QI while the LLC sells the remaining land and allocates the gain to B assuming B desires cash?
- Might the LLC receive an installment note from the buyer and dist. the note to B?

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Co-Tenancy Issues

- As stated, a partnership interest is not like-kind to real property and such an interest cannot be exchanged
- A co-tenancy must therefore not be viewed by the IRS as a partnership interest
- This determination involves a number of factors with the level of management activity by the co-owners of prime importance
- Syndicated TIC industry gave rise to Rev Proc 2002-22 which is important for a TIC owner to review

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Debt in Exchanges

- To accomplish a deferred exchange without taxable boot in instances where the property is encumbered, the taxpayer must:
  1. Use all exchange funds (cash) in the replacement property or properties, and
  2. The replacement properties must have debt equal to or greater than the debt on the relinquished properties

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Debt in Exchanges

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- Facts: Tax basis in property is $500k while FMV is $2.5M and the liability (1st deed) is $1.5M. There are three partners each with the negative capital account of $333,333
- Asset sells on December 1st (calendar year partnership owns asset) and the debt is paid at closing and the net cash placed with the QI
- Normally, the debt retirement would cause a deemed cash distribution at 12/31 to the partners and resulting gain—this event is deferred under 1031 transactions

Related Party Issues

- While a taxpayer is allowed to exchange with a related party, Section 1031 (f) provides some limitations
- Non recognition is not allowed when either the taxpayer or the related party disposes of the property they received within 2 years of the date of the last transfer
- The rules were established to prevent the ability to shift basis among assets held by related parties
- Related under Sections 267 (b) or 707 (b)

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State Income Tax considerations

- Make certain the state in which the relinquished property is sold does not require the replacement property to be in that same state
- QI's find themselves needing to make non resident withholding in some states so plan ahead

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Delaware Statutory Trusts

- Viewed by many as much more flexible than the TIC structures used by syndicators
- A DST allows institutional multi-owner offerings that qualify as like-kind for real estate in an exchange (Rev Ruling 2004-86)
- The DST provides liability protection with lenders generally making non recourse loans to the DST

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Questions?

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