



Real Estate Investors — Learn Tax Strategies for Section 1031 Exchanges

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Agenda/Learning Objectives

Introduction & basics

Mathematics/calculations and examples

Deeper dive on focused transactional scenarios

- Delaware Statutory Trust (DST)
- Vacation Home Safe Harbor
- Partnership/Tenant-in-Common (TIC)
- Seller Financing

2023 Future forward – What is on the horizon

How can CLA and First American Exchange help



Definition

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 for productive use in a trade or business or for investment



Types

- **Forward**

Most common. Relinquish a property, identify replacement options, close within 180 days from sale.

- **Reverse**

Acquire the replacement property prior to selling the relinquished property.

The replacement property is acquired and held by an EAT until the relinquished property is sold.

- **Improvement**

Include the value of planned/completed improvements to the replacement property in the exchange.

Can be a forward or reverse exchange.



Reverse Exchanges

- Most commonly, replacement property is “parked” with “EAT” (exchange last reverse)
- Relinquished property “parked” (exchange first reverse)
- EAT does not need benefits/burdens ownership (Rev. Proc. 2000-37)
- 180-day time limit
- Costs, financing



Improvement Exchange

- EAT holds title while improvements are added
- Investment replaced before 180 days
- Which improvements qualify?
- Title transferred to taxpayer



Capital Gains Tax

Sales Price:		\$1,000,000
Original Price:	-	\$ 300,000
<hr/>		
Gain:		\$ 700,000



Capital Gains Tax

Taxes on sale @ \$700,000 gain and \$150,000 depreciation:

Long-term federal capital gain rate (15-20%)

Income below \$492,300 indiv; \$553,850 married – 15%

Income above that – 20%

State Income Tax (if applicable)

Depreciation Recapture (25%)

Medicare Tax (3.8%) Individual w/AGI of \$200,000;

Married w/AGI of \$250,000

Estimated Total Taxes = \$174,800 - \$209,800



Benefits of Exchange

	<u>Sale</u>	<u>Exchange</u>
Equity	\$1,000,000	\$1,000,000
Cap. Gain Tax	<u>- 209,800</u>	- <u>(deferred)</u>
Cash to Reinvest	\$790,200	\$1,000,000

Leveraging cash into a 75% loan-to-value purchase:

Purchasing Power:	\$3,160,800	\$4,000,000
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Effect on Replacement Property



Gain deferred reduces basis in REP property



Taxes become due upon a taxable sale of REP property



Can continually exchange and defer taxes indefinitely



Tax liability is not passed onto heirs, as heirs receive a stepped-up basis



Fully Deferred Exchange

The “Napkin Test”

For 100% deferral of capital gains tax:

- Trade equal or up in value and equity
- Replace debt with debt or cash
- Taxed on greater of trade down in value or cash received (“Boot”)



Balancing the Exchange

Example 1: Equal value and greater equity

Relinquished Property

Value \$1,000,000

Loan: \$ 500,000

Equity: \$ 500,000

Replacement Property

Value: \$1,000,000

Loan: \$ 400,000

Equity: \$ 600,000

[\$500,000 debt relief offset by \$400,000 new debt and \$100,000 cash added
= NO BOOT]



Balancing the Exchange

Example 2: Lower value and equal equity

Relinquished Property

Value \$1,000,000

Loan: \$ 500,000

Equity: \$ 500,000

Replacement Property

Value: \$800,000

Loan: \$300,000

Equity: \$500,000

[\$500,000 debt relief is partially offset by \$300,000 new debt, but the remaining \$200,000 of debt relief is TAXABLE MORTGAGE BOOT]



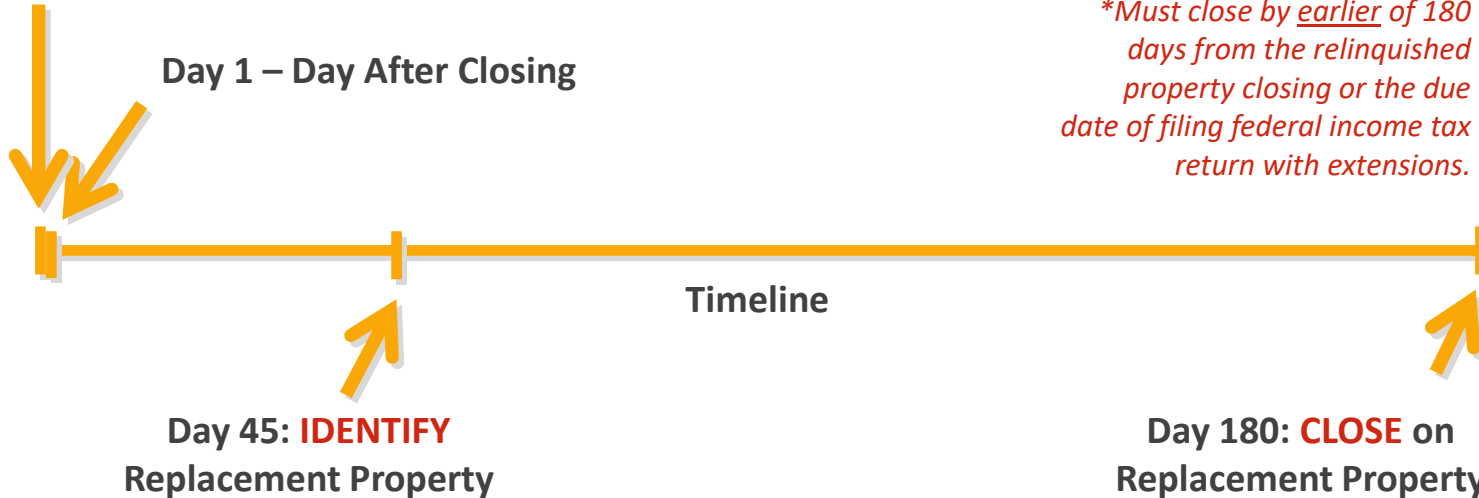
Exchange Requirement

- Must be documented at or prior to closing.
 - Exchange Agreement limiting the taxpayer's rights to proceeds. Treas. Regs. 1.1031(k)-1(g)(6)
 - Assignment of Contract to QI
 - Contract must be assignable
 - Notice of assignment to other parties
- No receipt of funds by taxpayer - Must be sent from escrow to QI.
 - No constructive receipt



Timeframes for an Exchange

Day 0 – Closing of Relinquished Property



No extensions – even if deadline is a Saturday, Sunday or a legal holiday.



Identification Rules

Must be in writing, signed,
sent by the 45th day

- 3-Property Rule
- 200% Rule
- 95% Rule
- No contract required

**KNOW THE
RULES!**



Like Kind Requirement

- All U.S. Real property is like kind
 - Fractional interest or 100% interest
 - Lease with 30+ year term
 - Oil and gas rights
 - Perpetual easements
 - Foreign property for foreign property
- Not personal property
- Not stocks, bonds, or partnership interests
- Not REITs



Delaware Statutory Trusts

- Like kind - Revenue Ruling 2004-86
- Acquire interest in an entity that owns one or more properties
- Sold as securities, through a securities rep
- **Advantages:** No management responsibilities, diversify investments, invest leftover funds
- **Disadvantages:** Lack of control, illiquid



Vacation Homes

IRS issued: Revenue Procedure 2008-16

- 24-month compliance period
- Each 12-month period:
 - Rent property at least 14 days at FMR to a non-relative
 - Limit personal use to no more than greater of 14 days or 10% of days rented
- Applies to properties on both sides



Same Taxpayer Requirement

Same taxpayer who transfers relinquished property must acquire replacement property, IRC §1031(a)(3)

Favorable exceptions:

- Disregarded single-member LLC and the sole member
- Grantor/Revocable Trust – Disregarded entity
- If taxpayer passes during exchange, their estate may complete the exchange, Rev. Rule 64-161



Partnerships

- Generally can't exchange member interest in LLC/LLP/GP
- Revenue Ruling 99-5/99-6
- Drop and Swap
 - Distribute property to individual partners before Sale
 - Individual owners can exchange or take cash
 - Not without risk



Partnerships

Practical Tips

- Drop out of the entity before the sale discussions
- When dropping into TIC interests, follow Rev Proc 2002-22, i.e., share in the profits and expenses on a pro rata basis, distribution of cash/operating income
- Negotiate and enter into the sale agreement as individuals
- Alternative options (pre/post redemption or contribution)



Partnerships

Challenges: IRS could attack on “step transaction” or “substance over form” doctrines; holding period

Favorable Case Law:
Magneson v. Comm., 753 F. 2d 1490 (9th Cir. 1985), *Bolker v. Comm.*, 760 F. 2d 1039 (9th Cir. 1985), and *Maloney v. Comm.*, 93 T.C. 89 (1989)

Seller Carryback Note

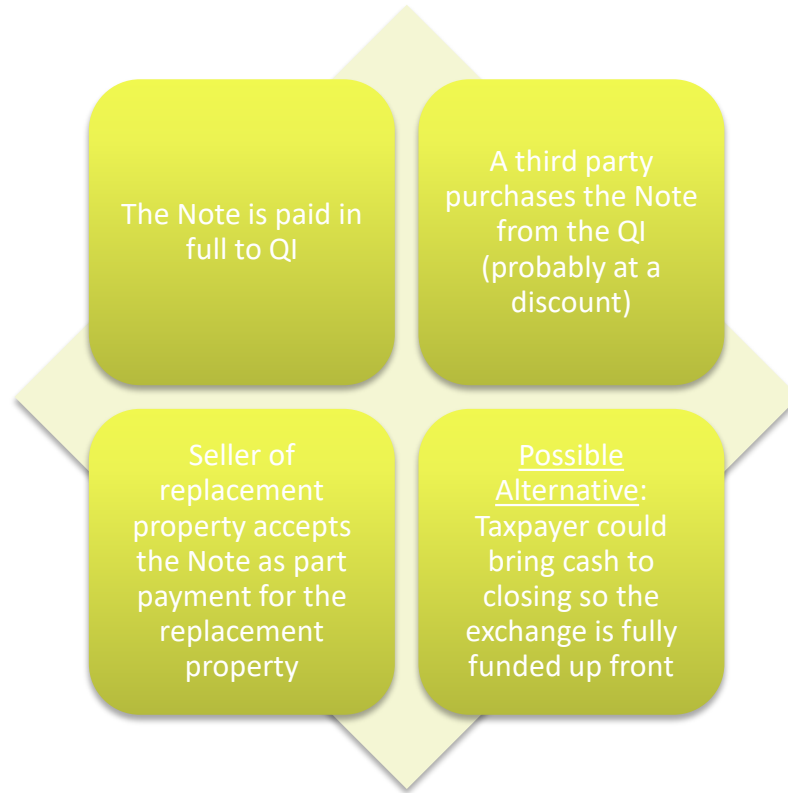
Example: \$1 million
property; \$300K
cash, \$700K note

Note **excluded**
from exchange
(boot): Payable to
taxpayer; may be
reported under
§453

Note **included** in
exchange: Payable
to QI, and one of
the following must
occur during the
exchange period:



Seller Carryback Note (cont'd)



Future Of 1031

- President Biden's 2024 budget proposal seeks to limit the capital gains deferral to \$500K per person (\$1M per married couple) per year. Any gain over that amount would be taxable. Carry over from previous two years' proposals (was expected).
- Federation of Exchange Accommodators (FEA) and its coalition partners continue to lobby lawmakers, to stay in front of the issue.
- Economic studies (Ernst & Young, Ling & Petrova) show there is a large economic impact if 1031s capped/repealed, including:
 - Loss of nearly 1M jobs and labor income
 - Reduction in highest and best use of properties
 - Loss of industry's \$97M+ contribution to US GDP
- To send an electronic letter to your congressional representatives to keep 1031 exchanges:
<https://1031buildsameric.org/take-action>





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Thank you for joining us!

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