Real Estate Investors – Learn Tax Strategies for Section 1031 Exchanges

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Agenda

Introduction and basics

Purpose of Sec. 1031 exchanges

Deeper dive

- Types of exchanges
- Role of Q.I.
- Basic guidelines
- Common pitfalls

How can CLA and IPX 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 either for productive use in a trade or business or for investment

What Does That Mean for You?

A taxable sale may include such taxes as:

- Federal capital gains tax
- Federal tax on depreciation recapture
- Federal net investment income tax
- State capital gains tax

Potential to defer both federal and state taxes on property sale

Ability to invest more dollars into real estate

Basic 1031 Transaction Types

Forward

Sell your property then acquire the new

Reverse

Acquire the new property and then sell yours

Improvement

Construct improvements to property during 180-day period

Role of 1031 Company / Qualified Intermediary

Safeguard funds

Generate 1031 documentation

Guide exchanger, broker,

and counsel through process

Basic Guidelines in a 1031 Exchange

Equal or greater

- Reinvest all sale proceeds
- Replace all debt

Taxpayer continuity

- Same taxpayer rule

Like-kind

- Investment or business use requirement
- Domestic for domestic
- Foreign for foreign

Time periods

- 45-day identification period
- 180-day exchange period

Breaking Down the Numbers

- The “napkin test”
- For 100% gain deferral, taxpayer must:
  - Trade up or equal in property value
  - Trade up or equal in equity

Napkin Test – Example 1

Equal value and greater equity

Relinquished Property		Replacement Property	
Value	$1,000,000	Value:	$1,000,000
Loan:	$ 500,000	Loan:	$ 400,000
Equity:	**$ 500,000**	**Equity:**	**$ 600,000**

Note: in this transaction, there is $100k of debt boot but is offset by $100k of additional cash

Napkin Test – Example 2

Lower value and equal equity

Relinquished Property		Replacement Property	
Value	$1,000,000	Value:	$800,000
Loan:	$ 500,000	Loan:	$300,000
Equity:	**$ 500,000**	**Equity:**	**$500,000**

Note: in this transaction, there is $200k of taxable boot despite 100% equity reinvestment

Same Taxpayer Requirement

Same taxpayer who transfers relinquished property must acquire replacement property

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. Rul. 64-161

What Properties Types May Qualify?

- Retail, office, and industrial
- Residential
- TIC and DST interests
- Raw land
- Long-term lease
- Mineral, air, oil, and gas rights
- Perpetual easements
- Vacation rentals

What Properties Types Typically Don't Qualify?

- Personal property
- Primary residence
- Property primarily held for sale
- Partnership interests

Property Identification Rules

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Three Property Rule

The Exchanger may identify up to three properties of any value.

200%

200% Rule

The Exchanger may identify more than three properties if the total fair market value of what is identified does not exceed 200% of the fair market value of what they sold

95%

95% Exception

If the Exchanger identifies properties in excess of both Rule 1 and Rule 2, then the Exchanger must acquire at least 95% of the value of all properties identified.

Common 1031 Pitfalls

- Related-party exchange
- Seller financing
- Partnership issues
- Reverse and improvement exchanges

Pitfalls: Related-Party Exchange

- Who may be deemed a related party?
  - Siblings, spouse, ancestor, lineal descendants
  - Corporations and/or partnerships with common control
- Why is it important?
  - Related party transactions can be denied 1031 treatment
- Permissible related party transactions
  - Related party swap
  - Both parties engaging in an exchange
  - Transactions with no basis shifting

Pitfalls: Seller Financing

- Exchanger has cash prior to closing
- Exchanger does not have cash prior to closing
- Partial exchange

Pitfalls: Partnership Transactions

- Partnership is selling property but partners have different goals
- Possible planning opportunities:
  - Buyout exiting partner
  - Distribute undivided interest to exiting partner
  - Drop and swap
  - Swap and drop

What Is a Reverse Exchange?

A Taxpayer needs to close on the acquisition of the Replacement property before the Relinquished can close.

Because IRC 1031 requires an "exchange" the taxpayer cannot own both the Relinquished and the Replacement properties at the same time.

Typically, the reverse exchange involves a third-party "parking" title until the taxpayer can complete the exchange.

Built to Suit Exchange

Like a reverse exchange, IPX 1031 enters the chain of title

Holds title until the improvements are completed

45 days to notify us of the improvements you’re going to make

180 days to complete the improvements

Polling Question

Would you like someone from CLA to contact you regarding Section 1031 consulting and/or compliance and reporting?

- Yes
- Not at this time

Thank you for joining us!

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