Nine Deadly Sins of 1031 Exchanges

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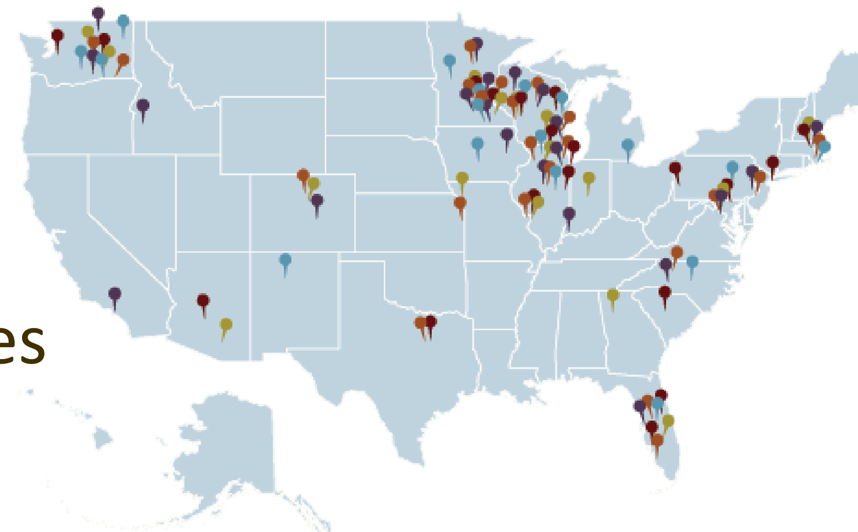

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Speaker Introductions

- **John Lang, J.D., CPA (inactive), President, Messerli & Kramer P.A.**
  John is the president of the law firm of Messerli & Kramer P.A. He focuses his practice on commercial real estate transactions. Many of those involve section 1031 exchanges. Mr. Lang has significant experience with Tenancy in Common (TIC) transactions and Delaware Statutory Trusts (DSTs) used in conjunction with 1031 exchanges. He is also a Certified Real Property Law Specialist certified by the Minnesota State Bar Association.
- **Jeff Peterson, J.D., Commercial Partners Exchange Company, LLC**
  Jeff is the president and principal of CPEC1031 – Commercial Partners Exchange Company. He travels throughout the United States as a speaker and continuing legal education presenter for various business and professional organizations on numerous issues related to 1031 exchanges and tax deferral strategies. Jeff is an attorney and adjunct tax law professor.
- **John Dorn, CliftonLarsonAllen**
  John is a tax principal with CliftonLarsonAllen and has 25 years of public accounting experience. He is an active member of CLA's real estate leadership team and is a frequent presenter and writer on taxation topics related to the real estate industry. John's technical experience includes partnership tax structuring and planning, transaction advisory for mergers, acquisitions, and reorganizations, as well as representation with the IRS and Departments of Revenue.

Learning Objectives

- At the end of this session, you will be able to:
  - Identify the basic requirements of a 1031 exchange
  - Describe the tax implications related to a 1031 exchange
  - Summarize a checklist for forward 1031 exchanges

1. What, I needed to set-up a 1031 exchange BEFORE I closed on the sale?

- Basic requirement — you must enter into an exchange agreement with a 1031 facilitator (qualified intermediary) before you close on the sale of the relinquished property, and provide written notice of your assignment of rights to all of the other parties to the sale contract
- Identification — you must designate your replacement properties within 45 days
  - Can't change the ID after the 45^{th} day
  - Delaware Statutory Trust comprised of multiple properties = more than one
- Must close within 180 days (or the due date of the federal tax return)
  - Escrows for post exchange improvements
  - Seller performance issues

2. I only want to re-invest my net proceeds, and don't want anymore debt.

There are three general rules of thumb to quickly see if you will defer all of the recognition of gain:

1. Typically you will acquire replacement property that is "up or equal" in **value** (price)
2. You will roll over all of your **equity** (net proceeds) from the relinquished property into your replacement property.
3. And to the extent that you were relieved of liabilities and **debt**, such as mortgages on your old relinquished property, the debt relief is offset by:
   1. new liabilities or mortgages taken on in conjunction with your purchase of the replacement property; OR
   2. by investing additional cash in the replacement property equal to the amount of liabilities and debts that were discharged.

3. If my exchange partially fails, I can get my basis back first, and do not recognize gains to the extent that I am being refunded by receiving my initial investment back.

- 39.6% Maximum Federal Ordinary Income §1245
- 25% Maximum Federal Deprecation Recapture
- 20% Maximum Federal Capital Gains
- 3.8% Maximum Net Investment Income Tax §1411
- State and/or Municipal Income Taxes/Capital Gains

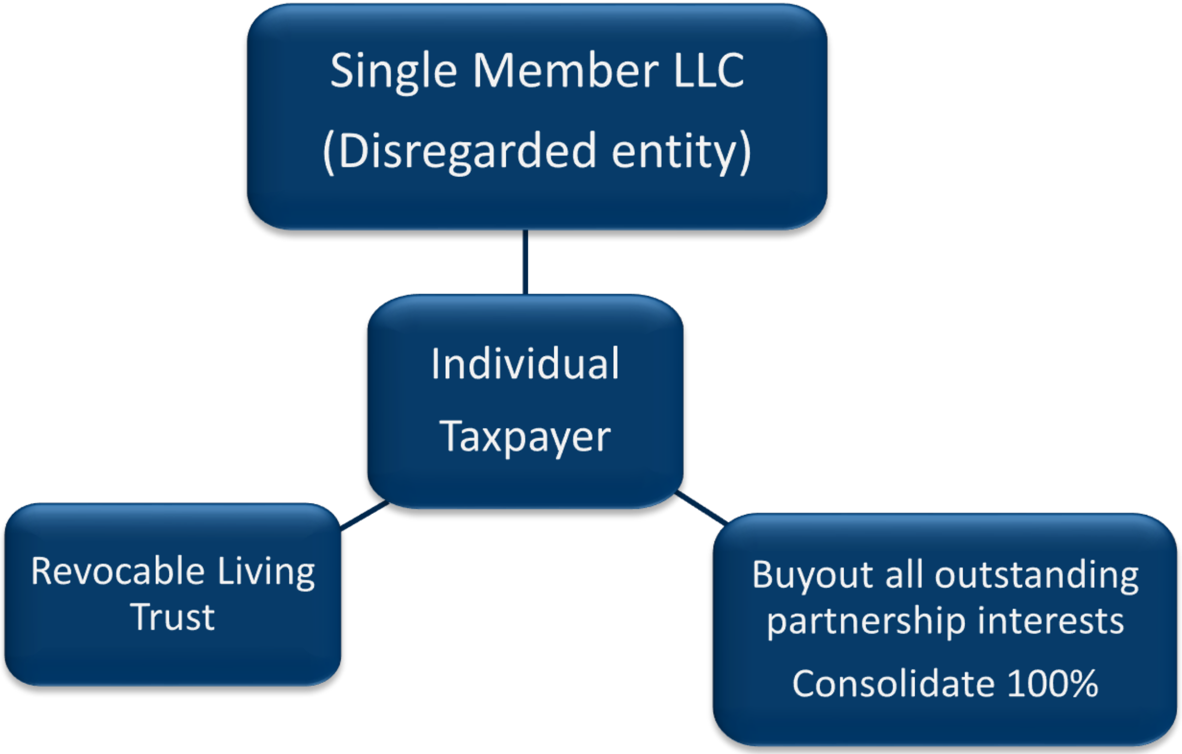
4. I am taking title to my replacement property in a new entity.

New S-Corp

New C-Corp

New LLC owned by Taxpayer and Spouse

T-I-C Tenant in Common
Filed Partnership Tax Returns



5. Our Partnership is disbanding and each Partner is going to a separate 1031 with their share of the Proceeds…no problem.

- Drop and Swap — Liquidating distribution into tenancy in common (stub tax return)
- Redemption – keep the old entity in place for exchange minded owners
- Swap and Drop
- Swap and Divide Partnership
- Divide Partnership
- Timing and Planning — How long should I hold my T-I-C interest? BOLKER 760 F.2d 1039 (1985)

6. I am moving into my replacement property as my home.

- Taxing authorities are skeptical of personal use on both the relinquished property (that is sold) and the new replacement property that is purchased
- Personal residence is antithetical to it being held for investment. Moore v. Commissioner, T.C. Memo. 2007-134
- Safe Harbor Rev. Proc. 2008-16 (allows some personal use limited to the greater of 14 days or 10 percent of the time it is actually rented; and tests each of the two years before or after the exchange)

7. I am not going to worry about what my replacement property will be until much later.

- Start looking for replacement property before you sell
- Lock-up a replacement property with a purchase agreement or option to purchase before you close on the sale
- Purchase a replacement property with a Reverse Exchange and "park" it with the qualified intermediary for up to 180 days
- PLR 200712013 may be able to manufacture a buyer for the relinquished property
- Build-to-suit construction exchanges may be used to create a replacement property to the taxpayer's specifications (must identify the improvements that do not exist)

8. I am going to pay off my credit cards and other unrelated debts from the proceeds of the sale of the relinquished property.

- The repayment of the debt should be contractually connected with the sale of the relinquished property
- Can the debt be tied to the property by:
  - Amended and restated notes
  - Additional terms in the sale contract or exchange agreement
  - Mortgages, liens, and deeds of trust relating to the relinquished property

9. I am doing a 1031 exchange and taking back a note (or contract for deed) to finance my buyer's purchase.

- Receipt of the note or contract for deed may trigger boot
- Some workarounds:
  - Use a note and have the seller actually bring the loan money to closing so that the loan is not funded with the sale proceeds — that way all of the funds can go into the 1031 account
  - Run the note (of contract for deed) in favor of the qualified intermediary to insulate the exchanger from "constructive receipt“ or “actual receipt” of boot. Later, just prior to the closing of the replacement property, buy the paper from the qualified intermediary so that there is all cash in the 1031 account.
  - If the seller of the Replacement Property will accept the Note as partial payment, you may be able to allonge the note over together with other cash consideration

Checklist for Forward 1031 Exchanges

1. How much tax will be paid on the sale? (Is it worth it?)
2. Understand the reinvestment requirement
3. Do you have the requisite intent for both relinquished and replacement properties? (Productive use or investment)
4. Understand the statutory time limits for forward exchanges (45 days to identify; 180 days to close; they are not to be ignored)
5. Cash will stay in escrow at least 45 days or longer (45 days if no identification; 180 days if identification)
6. Make sure the correct taxpayer is used on both ends of the exchange
7. Inquire about and deal with any entity/partnership issues early on.
8. If the taxpayer wants cash, determine whether to take taxable boot or refinance before or after exchange.
9. Do not take constructive receipt of any exchange funds
10. Is there to be seller financing on the relinquished property? (Make sure it is structured correctly; i.e., note to QI.)
11. Does the relinquished property carry any depreciation recapture?

Replacement Property Issues for 1031 Exchanges

1. Locate replacement property early, early, early (maybe purchase before closing on relinquished property)
2. Make sure it is like-kind property (issues with personal property and personal use property)
3. Do you want to complete an improvement on the property? (Make sure you have thoroughly reviewed and decided how to accomplish this)
4. Are there related parties? IRS will challenge if there are
5. Is there to be co-ownership of replacement property?

Mechanical Issues

1. Should exchange cooperation language be included in the relinquished property or replacement property purchase and sale agreement? *Yes*
2. Should exchange language be included in the deed for either the relinquished property or replacement property? *No*
3. Review the settlement statement carefully for items that may result in taxable boot (i.e., prepaid rent, security deposits, loan fees, etc.)

Reverse Exchanges (acquiring the replacement property first)

1. Revenue Procedure 2000-37 creates an easy safe harbor – use an EAT
2. How will the taxpayer finance the acquisition of the replacement property?
3. Are there additional transfer taxes?
4. Are you likely to close on the sale of the relinquished property within the 180 day safe harbor period?
5. Understand the role of the EAT and the taxpayer

Questions?

Thank you!

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