When to Consider a Section 1031 Exchange

April 12, 2023

CDEC
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Agenda

- Introduction to the mechanics
- Case studies, common roadblocks
- 2023 Future forward – What is on the horizon
- How can CLA and CDEC 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

Exchange Requirement

The Taxpayer may not actually or constructively receive the proceeds of the sale.

Crandall & Dulin v. Commissioner T.C. Summary Opinion, 2011-14

Morton v. U.S., 107 AFTR 2d 2011

Four Types

- **Delayed (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 held by the QI until the relinquished property is sold.

- **Improvement**

Use proceeds from the relinquished property sale to fund improvements on the replacement property.

Can be a forward or reverse exchange.

- **Simultaneous**

Relinquish a property and acquire the replacement property at the same time

Forward Exchange

- Most common form of a Section 1031 transaction
- Proceeds from the sale are held in escrow until closing on the replacement property
  - Proceeds are typically held with a QI, escrow agent, or with your title company.
- Identify your replacement properties
- Close the purchase of the new property using the proceeds held by the QI
- No limit on how many Section 1031s a single person can execute

Business or Investment Use Property

Example:

Taxpayer sells relinquished property in August and enters into a tax-deferred exchange.

Taxpayer acquires replacement property in November.

In January of the following year, Taxpayer receives and accepts an offer to sell his newly acquired replacement property to the owner of adjacent property.

Can Taxpayer structure the transaction as an exchange?

Has Taxpayer held the replacement property for the requisite intent?

Business or Investment Use Property

PLR 8429039

Two years of business or investment use is sufficient to meet the requirement that the property was held for the requisite intent.

Neal T. Baker Enterprises, Inc. v. Commissioner (1998)

Taxpayer exchanges 48 vacant lots after owning them for 11 years.

The exchange was disallowed, and Taxpayer was deemed to have held the lots primarily "for sale."

Reverse Exchange

- Challenges
  - Taxpayer can’t take title of replacement (EAT)
  - Usage and need for agreements
  - Funding of initial purchase

- Where does the QI and CPA come in
  - Review and execute proper structure and documentation

Improvement Exchange

- Challenges
  - EAT/QI set up SMLLC to acquire
  - Agreements between taxpayer and EAT to facilitate improvements
    - Lease and Promissory Note
  - Taxpayer can’t previously own the land/property
  - Proper identification - specifically ID pending construction/improvements
  - 180-day timeline = actual completed/constructed
  - Increased cost

Improvement Exchange Continued…

- Opportunities
  - Upfront consulting and forming precise business plan/purpose
  - Review and execute necessary agreements
  - Model out necessary costs needed to defer 100% of realized gain
  - Separate taxpayers
  - Safe Harbor and Court Cases

Terms

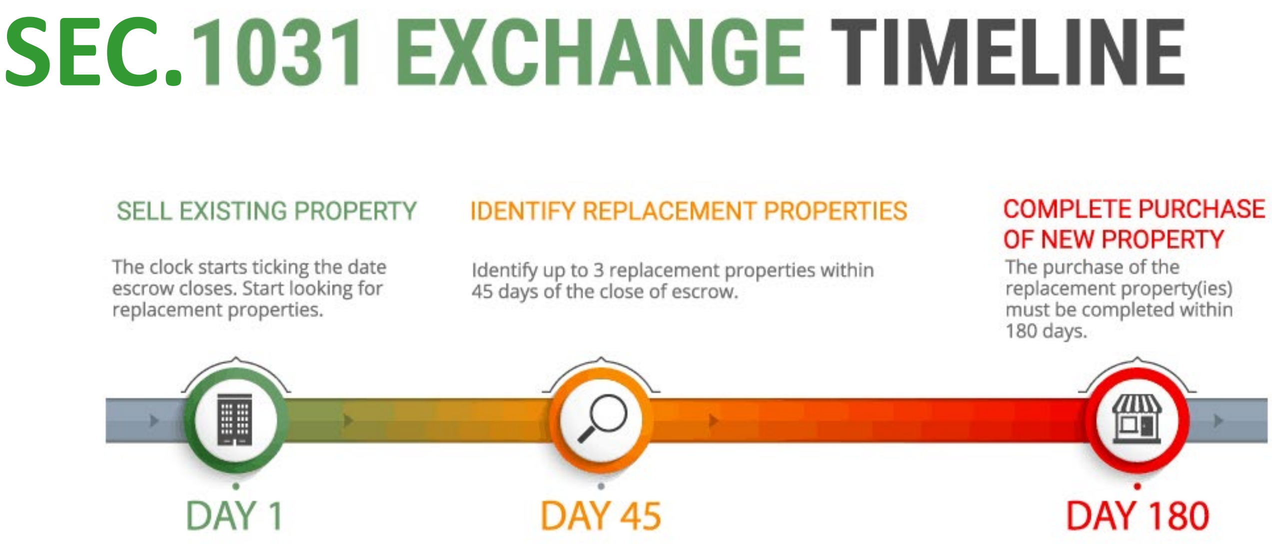
Real property

Land plus anything growing on it, attached to it, or erected on it. Essentially anything that cannot be removed without disrupting the land. As it relates to Section 1031, certain shorter life assets can be deemed part of the FMV of the property, but you should consult with your CPA.

Like-kind property

- Both properties must be held for business use or investment (no personal use)
- Property in the same nature, character, or class (quality or grade does not matter)
- Personal property can be included, but real property cannot be like-kind to personal property (additional rules pertain to the qualifications for personal property)

Timeline of Deadlines



- **Day 1** – Sale or Purchase *(forward vs. Reverse)*
- **Day 45** – Identify replacement or relinquished property
- **Day 180** – Complete the sale

Rules - Replacement Property

Mind the deadlines!

Property Identification – Pick one of the following to work within:

- **3 Property Rule**

You can identify up to 3 replacement properties and can acquire all 3, 2 of them, or just 1.

- **200% Rule**

Can be elected if you'd like to identify more than 3 replacement properties. This election allows you to identify any number of replacement properties, so long as the total FMV of what is being identified does not exceed 200% of the FMV of the relinquished property.

- **95% Rule**

Less common. This rule allows you to identify more than 3 properties with a total FMV that exceeds 200% of the FMV of the relinquished property, but only if you acquire at least 95% of the value of the properties that are identified. You would essentially need to acquire all Properties identified, which is why this is less common.

Rules Continued…

- **Property acquired within 45-day period**

Property acquired within the 45-day identification window can be used as whole or partly of the replacement property value.

- **Manner of Identification**

The identification must be in writing and signed by the taxpayer. The properties must be unambiguously described. This generally means using the address, PIN, and/or legal description. If you are acquiring less than 100% interest, the percentage share of what is being acquired should be noted

- **Who Receives the identifications**

Generally, your Qualified Intermediary.

Planning/Consulting

- Know gain/tax exposure
  - Wholistic tax picture
- Review debt/equity prior to entering into an exchange
  - FMV and debt modeling
- Taxable boot = Recognized Gain
  - Decrease in FMV or Equity can cause taxation
  - Non exchange expenses – trap for the unwary

Taxable Boot Example

	Relinquished	Replacement
FMV	$100,000	$150,000
Debt	$25,000	$100,000
Equity	$75,000	$50,000
Boot to balance (taxable gain)		$25,000

*For example purposes, the property sale would have resulted in a $50,000 gain if sold as a fully taxable sale.

Maximizing Tax Deferral – Avoiding Boot

Boot Netting Rules

The rules regarding the effect of receiving boot are found at Treasury Regulation 1.1031(b)-1.

General Rules to Maximize Deferral

1. Acquire replacement property of equal or greater value than the relinquished property;

AND

2. Reinvest all equity into replacement property

Planning/Consulting

TIC (Tenant in Common)

- Commonplace in Section 1031 transactions
- Drop and Swap OR Swap and Drop
- LLC interests are generally not eligible for Section 1031 deferral

DST (Delaware Statutory Trust)

- Passive alternative investment vehicle to defer gain
- ID needs to be specific
- Review FMV/Debt ratios

Planning/Consulting Continued…

Same Taxpayer Rule

- Same taxpayer must relinquish and replace
- SMLLC/Disregarded entities not an issue

Partnership Interests

- Pre or Post redemption of member interest
- 99-6 transaction – sole member deemed to purchase asset

Planning/Consulting Continued…

Seller Financing

Need to review options to ensure no deemed receipt of note occurs and generates taxable boot

Refinance

Review options to refinance immediately before or after completed exchange – tax free

Loan Holdbacks

Loan proceeds tied to future improvements review debt assumed on replacement property

Planning/Consulting Continued…

- Cost Segregation Interplay
  - Bonus eligible is only the excess basis
  - Carryover basis not bonus eligible and keeps relinquished properties attributes
  - Election to restart depreciable life but this doesn’t allow additional bonus elections
- Depreciation Recapture
  - Accelerated 1245 or 1250 ordinary income subject to potential recapture even if no taxable boot
  - Review recapture exposure and FMV of both relinquished and replacement property

2023 Horizon

- Biden proposed Greenbook plan details out the desire to remove Section 1031 exchanges from the code

- Review Section 1033 rules and benefits
  - Involuntary conversion (casualty)
  - Eminent domain (expropriate)

- Continue to review Section 1031 opportunities and plan accordingly

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