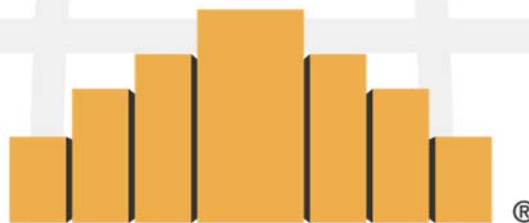




§1031 TAX-DEFERRED EXCHANGE ISSUES IN TODAY'S MARKET



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1031 Exchanges in Today's Market

- Capital Gain Taxation
- IRC Section 1031 and Exceptions
- Partnership Issues in a 1031 Exchange
- Related Party Rules & PLRs/Tax Court Decisions
- Who is the Taxpayer in a 1031 Exchange/Entity Issues
- Like-Kind Real Property & Creative Property Alternatives
- Delayed Exchanges and Time Deadlines
- Delayed Exchange Identification Rules
- What Not to do in a Delayed Exchange/Multiple Properties
- Parking Arrangements (Reverse & Improvement Exchanges)
- Section 1031 and Section 121: Three Scenarios
- Qualified Intermediary (QI) Due Diligence





IRC §1031 Exchanges

- One aspect of the tax code provides real estate investors with a tremendous tax advantage – an IRC Section 1031 tax-deferred exchange.
- Section 1031 allows taxpayers holding real property for investment purposes to potentially defer all taxes that would otherwise be incurred upon the sale of investment property.
- 1031 exchange activity is significant as most taxpayers have significant capital gain.





Capital Gain Taxation

- 20% capital gain tax rate for high earners
- “Net investment income” 3.8% surtax pursuant to IRC Section 1411
- Capital gain taxation includes 4 components:
 1. Taxation on depreciation recapture at 25% - *plus*
 2. Federal capital gain taxes at 20% (or 15%) - *plus*
 3. 3.8% Medicare surtax on net investment income - *plus*
 4. The applicable state tax rate (0% - 13.3%)





The Code



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.





Exceptions

- Stock in trade or other property held primarily for sale
- Stocks, bonds, or notes
- Other securities or evidences of indebtedness or interest
- Interests in a partnership
- Certificates of trust or beneficial interest
- Choses in action





Poll Question #1





Property Held for Sale

- The purpose for which the property was initially acquired
- The purpose for which the property was subsequently held
- The purpose for which the property was held at the time of sale
- The extent to which improvements were made to the property
- The frequency, number and continuity of sales
- The extent and nature of the transaction involved
- The ordinary course of business of the taxpayer
- The extent of advertising, promotion of the other active efforts used in soliciting buyers for the sale of the property
- The listing of property with brokers





Allen v. United States

- Taxpayer was not able to prove their intent changed from holding for development to holding for investment.
- Allen purchased property in 1987, and from 1987 to 1995 Allen attempted to develop the property on his own.
- From 1995 to 1999, Allen brought in partners who contributed capital for development.
- In 1999, Allen sold the property to a developer.
- Allen made significant and extensive efforts to develop the property over many years and failed to substantiate when his actions changed with regard to the property.
- Ultimately, Allen failed to provide any evidence to prove that his intent changed during the time of ownership of the property.





§1031 - Partnership Issues

- **A Partnership/LLC 1031 Exchange Scenario:** A property is owned by a partnership/LLC. Some partners may want the partnership to stay together and do a 1031 exchange; others may want to do their own separate 1031 exchanges with their portion of the property; others may want to receive cash and pay the taxes owed.
- The fact the partnership owns a capital asset does not mean the partners have an ownership interest in that asset.
- The partners merely own partnership interests.
- Partnership interests are specifically excluded from Section 1031 under section 1031(a)(2)(D).
- Therefore, if a partner wants to exchange, they must convert the partnership interest into an interest in the capital asset owned by the partnership.





§1031 - Partnership Issues

- **“Drop and Swap”** - involves the liquidation of a partnership interest by distributing an interest in the property owned by the partnership.
- After completing the “drop” the former partner will have converted their partnership interest into an interest in the actual property, as a tenant-in-common with the partnership.
- The property can then be sold with the former partner and the partnership entitled to do what they wish (sale or exchange) with their respective interests.
- **“Swap and Drop”** - This alternative involves the same two steps but in the reverse order. The partnership completes the exchange (the “swap”) and then distributes an interest in the replacement property to the departing partner or partners.





§1031 - Partnership Issues

Holding Period Issues:

- If the “drop” occurs close in time to the “swap” (or visa versa) there may be a question as to whether the relinquished property (or replacement property) was “held for investment.”
- If the “drop” occurs too close to the “swap”, the partner’s exchange may be deemed an exchange by the partnership under the *Court Holdings* case.
- The more time that passes between the “drop” and “swap” the better.





§1031 - Partnership Issues

Holding Period Issues:

- Numerous federal cases (*Bolker, Mason, Maloney*) provide taxpayer-friendly authority against challenges by the IRS.
- Some state tax authorities, such as the Franchise Tax Board (FTB) in California, challenge the federal cases and argue they are not bound by the federal cases.
- Changes made in 2008 to the federal partnership tax return (IRS Form 1065) make it easier to detect when a drop and swap transaction has occurred, thus making such transactions more vulnerable to challenge by taxing authorities.





§1031 - Partnership Issues

Partnership Installment Note (“PIN”):



- An alternative is known as a partnership installment note (“PIN”) transaction which results in the gain associated with the “boot” is recognized only by the departing partners. In a PIN transaction, instead of receiving cash, the partnership receives an installment note in the amount necessary to cash out the departing partner(s).
- The note is transferred to the departing partner(s) as consideration for their partnership interests. If at least one payment under the note is received in the year following the 1031 exchange, the gain associated with the note is taxed under the IRC Section 453 installment method and recognized only when the actual payments are received by the departed partner(s).





Related Party Issues

Who is a Related Party?

Four Different Scenarios:

1. Simultaneous Exchange (Swap)
2. Delayed – Selling to a Related Party
3. Delayed – Purchasing from a Related Party
(See Rev. Ruling 2002-83, PLR 9748006)
4. Delayed – Purchasing from a Related Party who is
Exchanging (See PLR 2004-40002)





Related Party-Legal Developments

- **PLR 201216007** – Related Party Ruling: The non-tax exception to 1031 (f)(4) applies when related parties are also exchanging and receive a limited amount of boot. Each party must hold the replacement property for 2 years and permitted cash boot up to 5%.
- **PLR 2012120012** – Related Party Ruling: Involves successive exchanges and each taxpayer receives its own 45/180 day time period. Taxpayer had up to 540 days to complete their exchange.
- **The Malulani Group, Limited & Subsidiary, TC Memo 2016-209**
– Taxpayer purchased from a related party and the Court looked at the two taxpayers as a single economic unit.





Exchange Entities - General

Generally, the same tax owner should take title to the replacement property in the same manner they held title to the relinquished property. Some examples are below:

- Wife relinquishes, wife acquires
- Smith LLC relinquishes, Smith LLC acquires
- Gemco Corp. relinquishes, Gemco Corp. acquires
- Durst Partnership relinquishes, Durst Partnership acquires
- However, having the vesting the same is only a guideline.
- The key issue is the 'tax owner' of the relinquished property must acquire tax ownership of the replacement property.





Poll Question #2





Like-Kind Property





Like-Kind Property Issues

What Real Property is Excluded?

- Principal Residence
- Property Held for Sale / Dealer Property



Qualifying Real Property

- Any relinquished real property held for productive use in a trade or business or investment = replacement real property held for productive use in a trade or business or investment.





Creative Like-Kind Property Issues

- **Air Rights** - Air rights, also known as “Transferable Development Rights,” (TDRs) are defined as unused rights to develop a property to the extent permitted under state or local law.
- TDRs are “like-kind” to a fee interest in real property.
- In PLR 200805012, the “IRS” noted that “[t]he types of property rights and interests that constitute interests in real property...for purposes of §1031 are broad” and that “[w]hether property constitutes real or personal property generally is determined under state or local law.”





Creative Like-Kind Property Issues

Perpetual Communications Easement (Cell Tower)

- If the communication easement is perpetual (e.g., runs with the land), then there is another 1031 exchange structuring opportunity.
- The creation of a lease or the grant of a license results in a contract right to receive rent or license fees over time. Rents and license fees are generally included in the taxpayer's income when received.
- A perpetual easement can be exchanged for a fee simple interest.
- A conservation easement in a farm property can be exchanged for a fee simple interest in other real property.
- An agricultural use easements qualifies for tax deferral.





Creative Like-Kind Property Issues

Oil, Gas & Mineral Rights

- Permitted if the mineral rights constitute an interest in real property.
- The determination of whether real property depends on (i) the specific nature of the rights granted under the mineral contract (ii) the duration of those rights and (iii) whether state laws recognize the mineral interests as interests in real property versus personal property.
- A “production payment” is considered personal property because it is a right to receive income rather than an ownership interest in the minerals.
- A royalty interest is generally considered real property due to the term of the interest. The royalty continues until the gas or oil is exhausted (contrasted with a production payment which terminates when a specified quantity of oil or gas have been produced.)





Vacation Home Exchanges

Revenue Procedure 2008-16

- Creates safe harbor for vacation home exchanges.
- IRS will consider a dwelling unit held for investment if certain requirements are met.



Requirements:

- The relinquished and replacement properties are owned by the taxpayer for at least 24 months (the qualifying use period);
- Within each of these two 12-month periods constituting the qualifying use period the taxpayer must:
- Rent the property to another person or persons at fair market rent for 14 or more days (family members qualify if they rent at FMV); and
- The taxpayer's personal use of the dwelling unit cannot exceed the greater of 14 days or 10 percent of the time it is rented.





Fractional Ownership

- What is a typical fractional ownership investment?
- Advantages of fractional ownership
- Risks involved in fractional ownership
- Tenant-In-Common (TIC): Rev. Proc. 2002-22
- Delaware Statutory Trust (DST): Rev. Rul. 2004-86
- For more information, visit: www.adisa.org





Intent to Hold for Investment

- “Intent” is the taxpayer’s subjective intent
- The IRS will look at objective factors that either support or negate the taxpayer’s intent to hold for investment
- All facts and circumstances taken into account
- The holding period is just one (of many) factors
- Ideally the taxpayer has multiple factors to establish the intent to hold for investment
- Contrary facts may lead the IRS to conclude the property was not held for investment purposes
- Goolsby v. Commissioner (April 1, 2010)
- Reesink v. Commissioner (April 23, 2012)





The Exchange Equation

For full tax deferral, a taxpayer must meet two requirements:

1. Reinvest all net exchange proceeds
2. Acquire property with the same or greater debt.

	Relinquished		
Value	\$900,000		
- Debt	\$300,000		
- Cost of Sale	\$60,000		
Net Equity	\$540,000		





The Exchange Equation

For full tax deferral, a taxpayer must meet two requirements:

1. Reinvest all net exchange proceeds
2. Acquire property with the same or greater debt.

	Relinquished	Replacement	
Value	\$900,000	\$1,200,000	
- Debt	\$300,000	\$660,000	
- Cost of Sale	\$60,000		
Net Equity	\$540,000	\$540,000	





The Exchange Equation

For full tax deferral, a taxpayer must meet two requirements:

1. Reinvest all net exchange proceeds
2. Acquire property with the same or greater debt.

	Relinquished	Replacement	Boot
Value	\$900,000	\$1,200,000	
- Debt	\$300,000	\$660,000	\$ 0
- Cost of Sale	\$60,000		
Net Equity	\$540,000	\$540,000	\$ 0

The taxpayer acquired property of greater value, reinvesting all net equity and increasing the debt on the replacement property.

Analysis: There is no boot.





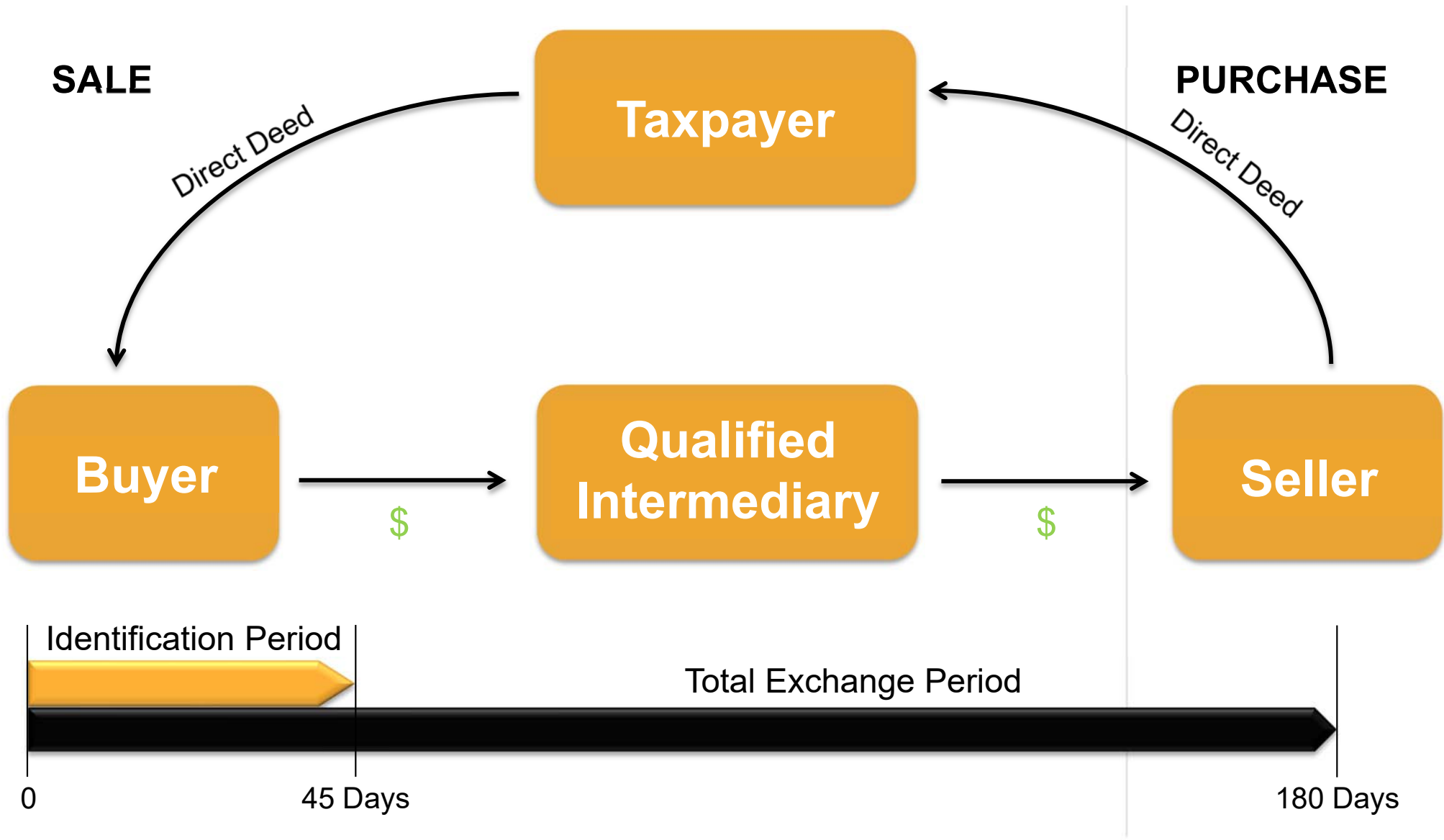
The Exchange Equation

	Relinquished	Replacement	Boot
Value	\$900,000	\$700,000	
- Debt	\$300,000	\$260,000	\$ 40,000
- Cost of Sale	\$60,000		
Net Equity	\$540,000	\$440,000	\$ 100,000
Total Boot			➔ \$ 140,000

The taxpayer acquired property of a lower value, keeps \$100,000 of the net equity and acquired a replacement property with \$40,000 less debt.

Analysis: This results in a total of \$140,000 in boot.
(\$40,000 mortgage boot and \$100,000 in cash boot = \$140,000)







Time Requirements



- ▶ **45 Day Identification Period:**

The taxpayer must identify potential replacement property(s) by midnight of the 45th day from the date of sale.



- ▶ **180 Day Exchange Period:**

The taxpayer must acquire the replacement property by midnight of the 180th day, or the date the taxpayer must file its tax return (including extensions) for the year of the transfer of the relinquished property, whichever is earlier.





Identification Rules

- **Three Property Rule:** The taxpayer may identify up to three properties of any fair market value.
- **200% Rule:** The taxpayer may identify an unlimited number of properties provided the total fair market value of all properties identified does not exceed 200% of the fair market value of the relinquished property.
- **95% Rule:** If the taxpayer identifies properties in excess of both of the above rules, then the taxpayer must acquire 95% of the value of all properties identified.





Identification Rules

Identification must be:

- Made in writing
- Unambiguously describe the property
- Hand delivered, mailed, telecopied or otherwise sent
- Sent by midnight of the 45th day
- Delivered to the Qualified Intermediary or a party related to the exchange who is not a disqualified person





Poll Question #3





What Not To Do In An Exchange

WHAT NOT

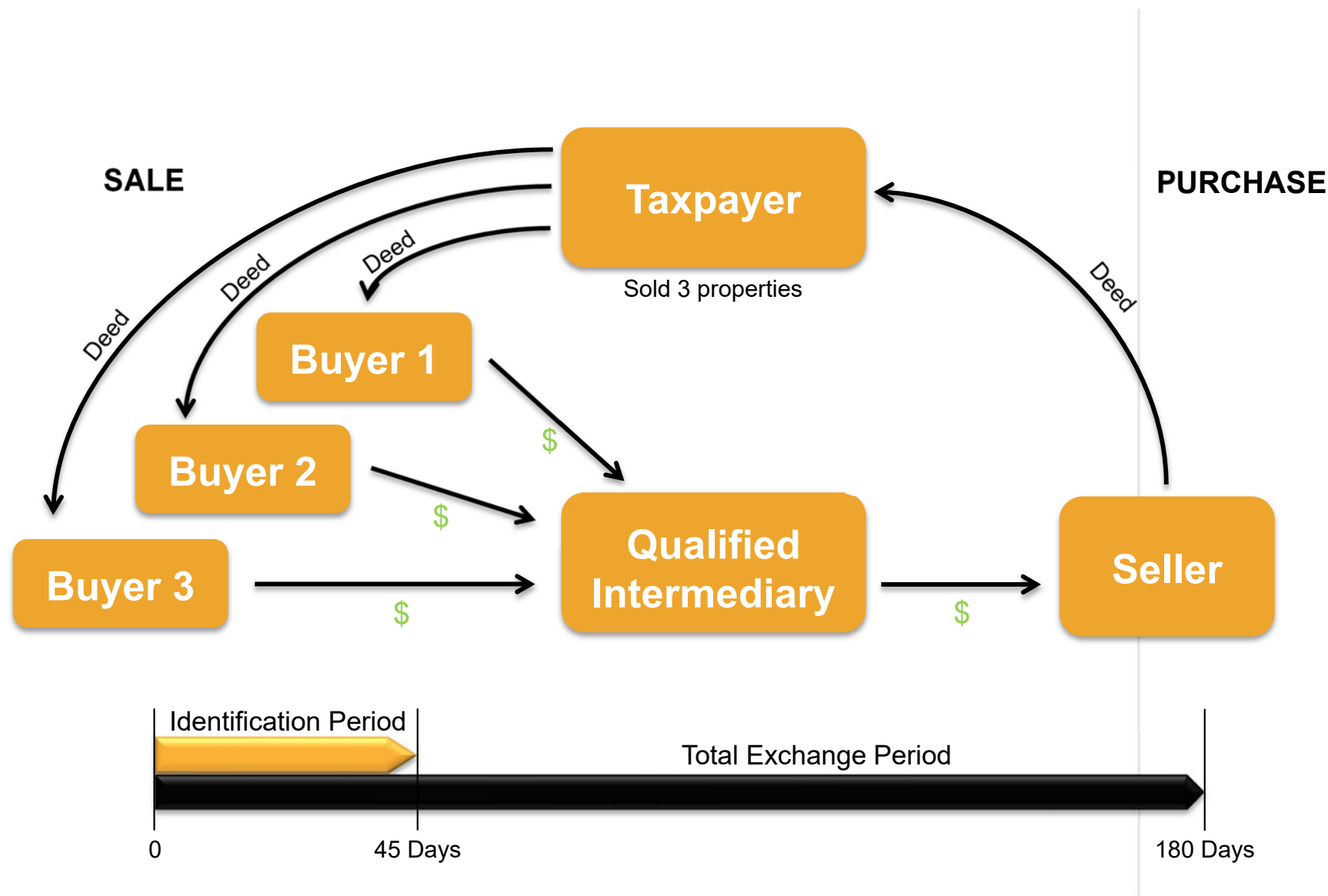
TO DO

- Christensen v. Commissioner
(Didn't file extension to obtain full 180 days)
- Knight v. Commissioner
(Closed after the 180th day)
- Dobrich v. Commissioner
(Backdated the Identification Notice)



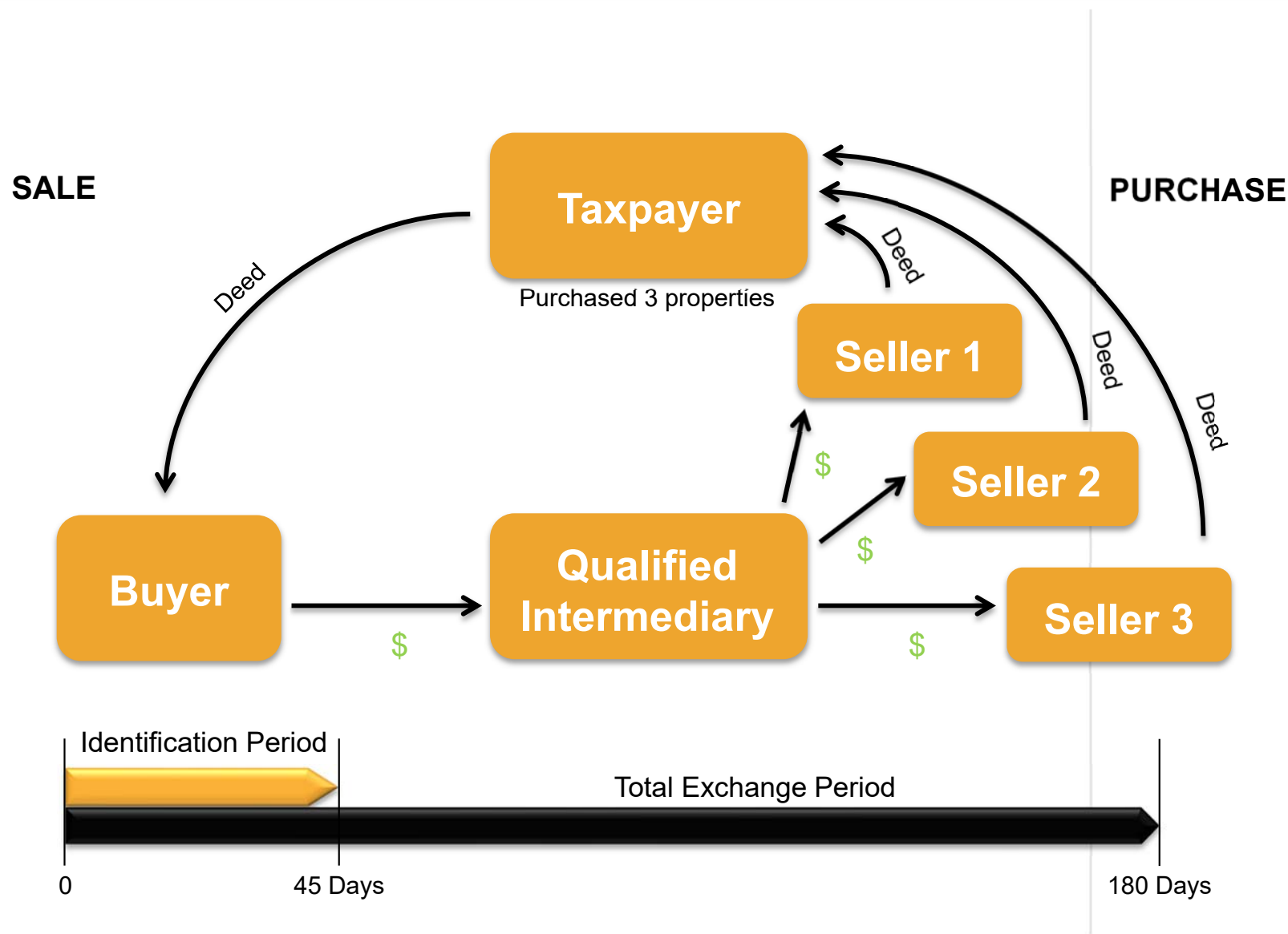


Multiple Property Exchanges





Multiple Property Exchanges





Parking Arrangements

What is a Reverse Exchange?

- Purchasing the replacement property before the sale of the relinquished property.

What is an Improvement Exchange?

- Building a new replacement property from the ground-up or making improvements to an existing replacement property.

What is a Reverse/Improvement Exchange?

- Purchase the replacement first and begin construction before closing on the sale of the relinquished property.





Rev. Proc. 2000-37

Effective September 15, 2000

- Provides a “safe harbor” for reverse exchange transactions that stay within the parameters of the Revenue Procedure.
- Reverse exchanges may be structured outside the safe harbor.





Poll Question #4





IRC Section 1031 and Section 121

IRC Section 1031

- Tax deferral on the sale of a property used in a trade or business or held for investment when exchanged for like-kind replacement property to be used in a trade or business or held for investment.
- Tax deferral (carryover basis rolls into rep. property)

IRC Section 121

- Tax exclusion on the sale of a principal residence held for two (2) of out five (5) years. Taxpayers meeting these requirements can exclude up to \$250,000 of gain if filing single and \$500,000 of gain if married filing jointly.
- Tax exclusion up to the threshold amounts





IRC Section 1031 and Section 121

Scenarios involving Section 1031 and Section 121

- §1031 tax deferred exchange (business or investment property)
- §121 principal residence sale (taxpayer lives in the property)
- Split treatment (portion §1031 and portion §121)
- Convert rental into residence (§1031 convert to §121)
- Convert residence into rental (§121 convert to §1031)





IRC Section 121

§121 Principal Residence Sale (taxpayer lives in the property)

- Tax exclusion
- Taxpayer must use the property as a principal residence for two (2) of the five (5) years prior to the sale
- The use does not need to be in concurrent months
- Exclusion of \$250,000 of gain for single filers
- Exclusion of \$500,000 of gain for married filing jointly
- §121 exclusion only available every two years
- Second homes and vacation homes do not qualify for §121 exclusion -- unless the taxpayer moves into the property and converts it to a principal residence for 2 out of 5 years.





Split Treatment (§1031 and §121)

Portion §121 (Residence) and a Portion §1031 (Investment)

- One property used partially as a principal residence and partially for business or investment purposes.
- Taxpayer and their tax advisor must allocate the portion used as a principal residence for tax exclusion under §121.
- Taxpayer and their tax advisor must allocate the portion used in a business or for investment which can qualify for tax deferral under §1031.
- Taxpayer can choose to receive proceeds directly from the closing on the principal residence allocation.
- Taxpayer can choose to have a qualified intermediary sell the portion allocated to business or investment in a §1031 exchange and acquire like-kind replacement property.





Split Treatment (§1031 and §121)

Sale of a Four Unit Property (Fourplex)

3 units rented (§1031)

1 unit used as a principal residence (§121)





Convert Rental into Residence

Convert Rental into a Residence (§1031 convert to §121)

- Must hold the property acquired in the §1031 exchange with the intent to initially hold for business or investment purposes.
- Ideally, the taxpayer should have facts/circumstances and documentation to support the intent to use in a business or hold for investment after the §1031 exchange.
- Minimum five (5) year holding period post-exchange.
- Taxpayer must use as a principal residence for at least 2 of the 5 years to be eligible for §121 tax exclusion.
- §121 exclusion is reduced by a ratio of the time the property was used as a principal residence compared to the time the property was used in a business or investment.
- Depreciation recapture taken during the time used in a business or held for investment is not excluded.





Convert Rental into Residence

Convert Rental into a Residence (§1031 convert to §121)

- An Example: Taxpayer performs a §1031 exchange into a replacement property which is rented for three (3) years. Taxpayer's intent changes and they move into the former rental property and live in the property for five (5) more years as a residence after initially renting for 3 years.
- Total ownership is 8 years (which is over the minimum 5 year holding period when converting a rental into a residence.)
- Taxpayer is eligible for 5/8 of the §121 tax exclusion since they lived in the property only 5 of the 8 years.
- The depreciation recapture during the 3-year rental time period is not eligible for tax exclusion.





Convert Residence into a Rental

Convert Residence into a Rental (§121 convert to §1031)

- Revenue Procedure 2005-14 provides guidance for the concurrent application of §121 and §1031 if a taxpayer has converted a principal residence into a rental property.
- Taxpayer must meet the requirements of §121 and have lived in the property for two (2) of the past five (5) years.
- Taxpayer has converted the principal residence into a rental.
- Taxpayer can exclude capital gain taxes up to the threshold amounts of §121 (\$250,000 single; \$500,000 married) – and perform a §1031 tax deferred exchange into a replacement property under §1031 which is to be held for investment or used in a business.
- Taxpayer obtains tax exclusion pursuant to §121 and tax deferral pursuant to §1031.





QI Due Diligence

- This is the most important choice a taxpayer will make in a Section 1031 exchange.
- Paramount to every 1031 exchange is the safety of funds held by the Qualified Intermediary (QI).





QI Due Diligence

- Does the QI offer customers the written backing of a large creditworthy entity?
- What is the financial rating and balance sheet of this entity?
- Does the QI conduct due diligence on the depositories holding the funds and monitor them?





QI Due Diligence

- Does the QI offer segregated accounts?
- Does the QI offer a qualified escrow account?
- Does the QI offer a qualified trust account?
- Does the QI have sufficient fidelity bond coverage?





Poll Question #4





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