§1031 TAX DEFERRED EXCHANGE ISSUES IN TODAY'S MARKET

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About Sarah Lindsay, CES®

- SVP, National Director of Sales & Marketing, Asset Preservation, Inc.
- Over 20 years in the 1031 exchange industry.
- Certified Exchange Specialist® (CES®) and Co-Chair of the CES® Council.
- Educator on advanced 1031 exchange topics.
- Works closely with taxpayers, CPAs, attorneys, Realtors®, and other advisors on complex exchange structures and planning opportunities.

Disclaimer

This presentation is only intended to provide a broad overview of IRC Section 1031 tax-deferred exchanges and does not address every potential 1031 exchange situation or all applicable 1031 exchange rules.

This tax-related information should not be construed as tax or legal advice specific to your situation and should not be relied upon in making any business, legal or tax related decision. A proper evaluation of the benefits and risks associated with a particular transaction or tax return position often requires advice from a competent tax and/or legal advisor familiar with your specific transaction, objectives and the relevant facts. You are urged to involve your tax and/or legal advisor (or to seek such advice) in any significant real estate or business-related transaction.

The Tax Problem - $1M All Cash Sale

Tax Type	Applies To	Rate	Tax Owed
Depreciation Recapture	$200,000 (Depreciation Taken)	25%	$50,000
Federal Capital Gain	$400,000 (Capital Gain)	15% or 20% (Assumed 20%)	$80,000
Net Investment Income Tax	$600,000 (Recognized Gain)	3.8%	$22,800
State Taxes	$600,000 (Recognized Gain)	Up to 13.3%	$79,800

TOTAL TAXES OWED = $232,600

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“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.”

IRC §1031 Exchanges

Taxpayers continue to explore strategies to reduce or defer taxes which has led to an increase in 1031 exchanges.

- Since 1921, one aspect of the tax code provides taxpayers who own investment real estate a significant tax advantage – an IRC Section 1031 tax-deferred exchange, more commonly referred to as a 1031 exchange.
- Section 1031 allows taxpayers holding real property for investment or business purposes to potentially defer all taxes that would otherwise be incurred upon an otherwise taxable sale of investment property.

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

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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 being held at the time of sale
- The extent to which improvements, if any, 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 sales of the property
- The listing of property with brokers

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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 (2010)
- Reesink v. Commissioner (2012)

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Notable Case Law Themes: Intent

- **Allen v. United States**
  - Acquired in 1987, attempted to develop on own until 1995, brought in partners in 1995, sold in 1999. Did not establish investment intent.
- **Goolsby v. Commissioner**
  - Sold investment and primary at same time. Bought property with 1031 that had rental restrictions. Moved in after 2 months. Did not Establish investment intent.
- **Reesink v. Commisioner**
  - Sold investment, bought investment. Tried to rent out unsuccessfully, 6 months later sold primary. Moved in 8 months after acquisitions. Other supporting facts. DID establish investment intent.

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Like-Kind Property

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Like-Kind Property

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 exchanged for replacement real property held for productive use in a trade or business or investment.

Real Property Definition Can be Broad

- Can include raw land, commercial, single-family rental (SFR), multi-family, office, industrial, easements, air rights, water rights, vacation homes held for investment under Rev. Proc. 2008-16, fractional ownership, etc.

Vacation Homes

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 pay fair market rent); 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.

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Creative Like-Kind Property Issues

Air Rights / Transferable Development Rights

The right to build above a property, or to transfer unused building rights to another property. For 1031 purposes, these can be like-kind if treated as real property rights under applicable law.

Oil, Gas & Mineral Rights

Rights to extract or benefit from oil, gas, or minerals under land. These can qualify as like-kind real property if the rights are considered an interest in real estate, rather than a short-term contract or personal property right.

Perpetual Easements, including Utilities, Cell Towers, Access Rights, etc.

A permanent right to use someone else's land for a specific purpose, such as utility lines, access, or cell tower equipment. Because the right is permanent and tied to the land, it may be treated as a real property interest for 1031 purposes.

Exchange Entities - General

Example	Seller	Buyer	Same Tax-Owner?	Notes
1. Individual to same individual	John Smith	John Smith	✓	Vesting and ownership remains the same.
2. Married man sells alone & buys with wife	John Smith	John Smith and Jane Smith	✓	Lives & owns property in community property states, and files jointly
3. Individual to fully disregarded LLC	John Smith	JS Enterprises, LLC (John Smith, Sole Member)	✓	A fully disregarded LLC is not a separate tax-owner
4. Corporation to corporation	ABC Corp.	ABC Corp.	✓	Corporation remains tax-owner throughout
5. Individual to LLC with multiple members	John Smith	J&M Enterprises, LLC (John Smith & Mike Anderson)	✗	LLC is separate tax-owner

The same *tax-owner* who sells must purchase. Vesting is not required to be the same.

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Exchange Entities – Exceptions

It is necessary to distinguish between 1) federal tax ownership, 2) state law ownership, and 3) vesting.

A taxpayer who elects taxation as a sole proprietorship (disregarded entity for Federal tax purposes) can sell relinquished property as an individual but acquire replacement property as a single member LLC.

An LLC with two members will be considered a single member LLC if the sole role of the other member is to prevent the other member from placing the LLC into bankruptcy and the limited role member LLC has no interest in profits/losses nor any managing rights.

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§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 exchange 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.

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§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.

§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).

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Related Parties in a 1031 Exchange

The Basic Rule: Two-Year Holding Requirement

If you do a 1031 exchange with a related party — or buy your replacement property from a related party — both sides must hold their respective properties for at least two years after the exchange. If either party sells or disposes of their property within that two-year window, the original exchange is disqualified and the deferred gain becomes taxable. Boot received is limited to 5%.

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Related Parties in a 1031 Exchange

Family relationships

- Spouse
- Siblings
- Parents, grandparents, children, and grandchildren

Entity relationships

- Common ownership or control
- Corporations, partnerships, LLCs, or trusts connected through more than 50% ownership or certain trust relationships

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Related Parties in a 1031 Exchange

Why does the IRS care?

The IRS is looking for transactions where related parties may be trying to:

- Shift basis
- Cash out of one property
- Avoid recognizing gain
- Use a QI to make a related-party transaction look like a standard exchange

Plain-English takeaway

If the taxpayer is buying from or selling to someone connected by family, ownership, or control, stop and review the related-party rules before assuming the exchange qualifies.

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Formats & Variations

- **Delayed Exchange** – Sell First → Buy Second (Most Common)
- **Simultaneous Exchange** – Sell and Buy at the Same Time (Variation of Delayed)
- **Swap Exchange** – Direct Property-for-Property Trade (Rare Today)
- **Reverse Exchange** – Buy First → Sell Second *(Parking Arrangement)*
- **Improvement Exchange** – Acquire and Improve Replacement Property During the Exchange *(Parking Arrangement)*
- **Reverse Improvement Exchange** – Buy First with Improvements Completed During the Exchange *(Parking Arrangement)*

Timelines

*Both 45 and 180 day timelines start on the same day

Identification Rules

3 Property Rule	200% Rule	95% Rule
The taxpayer may identify up to three properties of any fair market value.	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.	If the taxpayer identifies properties in excess of both of the other rules, then the investor 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

What Not To Do In An Exchange

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)

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Parking Arrangements

What is a Reverse Exchange?

- Closing on the replacement property before the sale of the relinquished property. Note: contracting to buy the replacement before the sale of the relinquished property does not constitute a reverse exchange.

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.

Leasehold Improvement Exchange

- Construct improvements on a long-term (30+ years) leasehold interest and transfer the leasehold interest with improvements to the taxpayer.

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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.

The Reverse Exchange

Parking the Replacement Property

POSITIVES:

- Exchange equity does not need to be present
- Allows for multiple relinquished properties

NEGATIVES:

- Lender may have issues lending to the Exchange Accommodation Titleholder (EAT)
- Beware Prepayment Penalty
- Nonrecourse to EAT-guarantee permissible

The Reverse Exchange

Parking the Relinquished Property

POSITIVES:

- Loan and purchase easier (direct loan to taxpayer)

NEGATIVES:

- Equity and debt should match at the beginning to avoid boot
- Lender issues (due on sale)

The Improvement Exchange

Why Perform an Improvement Exchange?

- The property to be acquired in the exchange is not of equal or greater value to property being sold.
- Build a new investment from ground-up.
- The new investment is of equal or greater value, but it needs refurbishments.

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The Improvement Exchange

…if not within the provisions of Section 1031(a) if the relinquished property is transferred in exchange for services (including production services). Thus, any additional production occurring with respect to the replacement property after the property is received by the taxpayer will not be treated as the receipt of property of like-kind.”

“The Improvement Exchange

Identification of Replacement Property to be Produced

…if a legal description is provided for the underlying land and as much detail is provided regarding construction of the improvements as is practicable at the time identification is made.”

The Improvement Exchange

How do the numbers work out?

Relinquished Property	
Sales Price	$5,000,000
Debt	$0
Cost of Sale	$300,000
Net Equity to QI	$4,700,000

Replacement Property	
Lot Purchase (cash)	$3,000,000
Draw 1 site work	$1,200,000
Draw 2 foundation	$500,000
Exchange Value	$4,700,000

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Revenue Procedure 2004-51

An exchange of real estate owned by a taxpayer for improvements on land owned by the same taxpayer does not meet the requirements of §1031.

See *Decleene v. Commissioner*, 115 T.C. 457 (2000); *Bloomington Coco-Cola Bottling Co. v. Commissioner*, 89 F.2d 14 (7th Cir. 1951). Rev. Rul. 67-225. 1967 2 C. B. 270, holds that a building constructed on land owned by a taxpayer is not of a like-kind to Taxpayer.

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IRC Section 1031 & Section 121

Five Scenarios Involving Section 1031 and Section 121

1. §1031 tax-deferred exchange (business or investment)
2. §121 principal residence sale (taxpayer lives in the property)
3. Split treatment (portion §1031 and portion §121)
4. Convert rental into residence (§1031 convert to §121)
5. Convert residence into rental (§121 convert to §1031)

Split Treatment (§1031 and §121)

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

- Duplex, Triplex, or Fourplex with an Owner-Occupied Unit
- Farm or Ranch with Both Residential and Investment Components
- Primary Residence with One or More Short-Term Rental Rooms
- Primary Residence with a Separate Home Office or Business Space

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 out of a rental they have held for 10 years into a replacement property which is then 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 18 years (Replacement is over the minimum 5 year holding period when converting a rental into a residence.)
- Taxpayer is eligible for 5/18 of the §121 tax exclusion since they lived in the property only 5 of the 18 years.
- The depreciation recapture is not eligible for tax exclusion.

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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.
- 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.

1031 Disaster Extensions:
A Specific Analysis

Taxpayer-Specific:
- Does the taxpayer meet the definition of “Affected Taxpayer”?
- Is the taxpayer having difficultly meeting their 1031 deadlines due to the disaster?

Exchange-Specific:
- When did the RLQ sale close?
- What are the current Identification Period and Exchange Period deadlines?
- Was an ID’d property substantially damaged by the disaster?

Disaster-Specific:
- What is the IRS-provided date of the disaster?
- What is the IRS-provided extended deadline date?
- What is the IRS-provided disaster area?

Federally Declared Disasters

The IRS' Process in Granting Extensions

The IRS issues a notice or guidance (an "**IRS Notice**") extending certain time-sensitive tax deadlines as a result of a federally declared disaster

- The IRS disaster extension notices can be found here: irs.gov/newsroom/tax-relief-in-disaster-situations

The IRS Notice will provide, among other things:

- The date of the disaster ("**Disaster Date**"),
- The area affected by the disaster ("**Disaster Area**"), and
- The extended date for all the affected time-sensitive deadlines ("**Extended Date**").

The IRS Notices typically state that the Extended Date applies to all time-sensitive tax deadlines contained in Section 6 of IRS Revenue Procedure 2018-58 ("**Rev. Proc.**"), which includes 1031 deadlines (the "**Section 6 Extension**"). In addition to the Section 6 extension, the IRS Notice typically grants the Section 17 extensions which apply ONLY to 1031 deadlines (the "**Section 17 Extension**").

- The Rev. Proc. can be found here: irs.gov/pub/irs-drop/rp-18-58.pdf

Section 6 and Section 17 provide a taxpayer with two different extension options, resulting in different extended dates. The taxpayer needs to determine which one they will proceed under.

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Two Extension Options for 1031 Deadlines

Section 6

Must meet definition of "Affected Taxpayer" (commonly, a taxpayer who lives in, or a business with its principal place of business in, the Disaster Area – but there are other ways to meet the definition)

Closing date of the relinquished property does not matter

Extends 1031 deadlines falling on/after the Disaster Date and before the Extended Date to the Extended Date. 1031 Deadlines outside of this window do not change

- Remember, the due date for your tax return for the year of the relinquished property sale closing may cut your exchange period short, and you may need to file for an extension of that due date

Section 17

Must meet definition of "Affected Taxpayer" **OR** be a taxpayer who is having difficulty meeting the 1031 deadlines ***due to the disaster*** *(Rev. Proc. Sec. 17.02(b)(ii) has examples)*

Only available if the relinquished property closed on or before the Disaster Date Extends 1031 deadlines falling on/after the Disaster Date ***to the longer of***: (a) the Extended Date; or (b) 120 days.

- The extension under this section cannot go beyond one year or the due date for the tax return for the year of the relinquished property sale closed, and so you may need to file for an extension of that due date

A retroactive extension of the ID period may be available if an identified replacement property was substantially damaged by the disaster

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Thank you.
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