



1031 Strategies in 2021 and Beyond

February 4, 2021

12:00 p.m. – 2:00 p.m.

CT Bar Association

Webinar

CT Bar Institute, Inc.

CT: 2.0 CLE Credits (General)
NY: 2.0 CLE Credits (AOP)

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LAWYERS' PRINCIPLES OF PROFESSIONALISM

As a lawyer, I have dedicated myself to making our system of justice work fairly and efficiently for all. I am an officer of this Court and recognize the obligation I have to advance the rule of law and preserve and foster the integrity of the legal system. To this end, I commit myself not only to observe the Connecticut Rules of Professional Conduct, but also conduct myself in accordance with the following Principles of Professionalism when dealing with my clients, opposing parties, fellow counsel, self-represented parties, the Courts, and the general public.

Civility:

Civility and courtesy are the hallmarks of professionalism. As such,

- I will be courteous, polite, respectful, and civil, both in oral and in written communications;
- I will refrain from using litigation or any other legal procedure to harass an opposing party;
- I will not impute improper motives to my adversary unless clearly justified by the facts and essential to resolution of the issue;
- I will treat the representation of a client as the client's transaction or dispute and not as a dispute with my adversary;
- I will respond to all communications timely and respectfully and allow my adversary a reasonable time to respond;
- I will avoid making groundless objections in the discovery process and work cooperatively to resolve those that are asserted with merit;
- I will agree to reasonable requests for extensions of time and for waiver of procedural formalities when the legitimate interests of my client will not be adversely affected;
- I will try to consult with my adversary before scheduling depositions, meetings, or hearings, and I will cooperate with her when schedule changes are requested;
- When scheduled meetings, hearings, or depositions have to be canceled, I will notify my adversary and, if appropriate, the Court (or other tribunal) as early as possible and enlist their involvement in rescheduling; and
- I will not serve motions and pleadings at such time or in such manner as will unfairly limit the other party's opportunity to respond.

Honesty:

Honesty and truthfulness are critical to the integrity of the legal profession – they are core values that must be observed at all times and they go hand in hand with my fiduciary duty. As such,

- I will not knowingly make untrue statements of fact or of law to my client, adversary or the Court;
- I will honor my word;
- I will not maintain or assist in maintaining any cause of action or advancing any position that is false or unlawful;

- I will withdraw voluntarily claims, defenses, or arguments when it becomes apparent that they do not have merit or are superfluous;
- I will not file frivolous motions or advance frivolous positions;
- When engaged in a transaction, I will make sure all involved are aware of changes I make to documents and not conceal changes.

Competency:

Having the necessary ability, knowledge, and skill to effectively advise and advocate for a client's interests is critical to the lawyer's function in their community. As such,

- I will keep myself current in the areas in which I practice, and, will associate with, or refer my client to, counsel knowledgeable in another field of practice when necessary;
- I will maintain proficiency in those technological advances that are necessary for me to competently represent my clients.
- I will seek mentoring and guidance throughout my career in order to ensure that I act with diligence and competency.

Responsibility:

I recognize that my client's interests and the administration of justice in general are best served when I work responsibly, effectively, and cooperatively with those with whom I interact. As such,

- Before dates for hearings or trials are set, or if that is not feasible, immediately after such dates have been set, I will attempt to verify the availability of key participants and witnesses so that I can promptly notify the Court (or other tribunal) and my adversary of any likely problem;
- I will make every effort to agree with my adversary, as early as possible, on a voluntary exchange of information and on a plan for discovery;
- I will attempt to resolve, by agreement, my objections to matters contained in my opponent's pleadings and discovery requests;
- I will be punctual in attending Court hearings, conferences, meetings, and depositions;
- I will refrain from excessive and abusive discovery, and I will comply with all reasonable discovery requests;
- In civil matters, I will stipulate to facts as to which there is no genuine dispute;
- I will refrain from causing unreasonable delays;
- Where consistent with my client's interests, I will communicate with my adversary in an effort to avoid needless controversial litigation and to resolve litigation that has actually commenced;
- While I must consider my client's decision concerning the objectives of the representation, I nevertheless will counsel my client that a willingness to initiate or engage in settlement discussions is consistent with zealous and effective representation.

Mentoring:

I owe a duty to the legal profession to counsel less experienced lawyers on the practice of the law and these Principles, and to seek mentoring myself. As such:

- I will exemplify through my behavior and teach through my words the importance of collegiality and ethical and civil behavior;
- I will emphasize the importance of providing clients with a high standard of representation through competency and the exercise of sound judgment;
- I will stress the role of our profession as a public service, to building and fostering the rule of law;
- I will welcome requests for guidance and advice.

Honor:

I recognize the honor of the legal profession and will always act in a manner consistent with the respect, courtesy, and weight that it deserves. As such,

- I will be guided by what is best for my client and the interests of justice, not what advances my own financial interests;
- I will be a vigorous and zealous advocate on behalf of my client, but I recognize that, as an officer of the Court, excessive zeal may be detrimental to the interests of a properly functioning system of justice;
- I will remember that, in addition to commitment to my client's cause, my responsibilities as a lawyer include a devotion to the public good;
- I will, as a member of a self-regulating profession, report violations of the Rules of Professional Conduct as required by those rules;
- I will protect the image of the legal profession in my daily activities and in the ways I communicate with the public;
- I will be mindful that the law is a learned profession and that among its desirable goals are devotion to public service, improvement of administration of justice, and the contribution of uncompensated time and civic influence on behalf of those persons who cannot afford adequate legal assistance; and
- I will support and advocate for fair and equal treatment under the law for all persons, regardless of race, color, ancestry, sex, pregnancy, religion, national origin, ethnicity, disability, status as a veteran, age, gender identity, gender expression or marital status, sexual orientation, or creed and will always conduct myself in such a way as to promote equality and justice for all.

Nothing in these Principles shall supersede, supplement, or in any way amend the Rules of Professional Conduct, alter existing standards of conduct against which a lawyer's conduct might be judged, or become a basis for the imposition of any civil, criminal, or professional liability.

1031 Strategies in 2021 and Beyond (EDU210204)

Agenda

1031 2021 First Quarter Summary

Tax Code Provisions

Capital Gain Taxes and other Tax Issues

IRC Section 1031 Requirements

The meaning of Hold For Investment

Like-Kind Real Property and Creative Like-Kind Property Variations

Exchange Entities

Partnership Options

The Exchange Equation

Closing Costs

Delayed Exchanges and Identification Rules

Seller Financing

G-6 Restrictions

Parking Arrangements (Reverse & Improvement Exchanges)

Split Treatment Transactions

FIRPTA

IRS Form 8824: Like-Kind Exchanges

Qualified Intermediary (QI) Due Diligence

Questions and Answers

Pamela A. Michaels, Esq. is an attorney and has been a Senior Vice President of Asset Preservation, Inc. for over 15 years. Pamela specializes in guiding attorneys, CPAs, investors, financial advisors and other real estate professionals through the regulations and requirements of IRC §1031. Pamela dedicates a significant portion of her time to providing practical presentations to accountants, attorneys, real estate brokers and investors throughout New York and the Northeast featuring real-life exchange scenarios to illustrate a wide range of investment and tax strategies.

Prior to joining Asset Preservation, Inc., Pamela served as an executive and general counsel to diverse financial organizations and real estate companies. Pamela became known early in her career for her work out strategies in the commercial sector and was successful in assisting a number of financial institutions resolve their non-performing real estate portfolios during the S&L crisis. Pamela has a strong background in the operational, financial and legal aspects of real estate, including real estate acquisitions, financing, construction and sales.

Asset Preservation, a subsidiary of Stewart Title Company, is a leading national IRC §1031 “Qualified Intermediary” and is efficiently handling exchanges in every state. Combining a national title company as a partner has proven to be the approach of choice by astute investors. Asset Preservation is one of the most respected national “Qualified Intermediaries” in the United States and has successfully completed over 150,000 §1031 exchanges throughout the nation and more than \$1 billion in exchanges in the Northeast alone.

Professional Involvement:

Member, Ohio Bar Association– since 1985

Member, Florida Bar Association-since 1986

Instructor: The Real Estate Board of New York, CCIM, ICSC, SIOR, CIBS, NJSSCPAs

Participation/Memberships: REBNY, CIBS, ICSC, NAREIT and ULI

Licensed NY Broker, since 2007

Articles and Publications:

Pamela is an author of numerous articles in publications including *The New York Real Property Law Journal*, *The New York Real Estate Weekly*, *The New York Real Estate Journal*, *The New York State Society of CPAs* and *The Midatlantic Real Estate Journal*. Select articles include:

1031 Exchanges and Opportunity Zones: What Qualifies and What Does Not Qualify, *The Mann Report*, 2019

Special Issues for Multi-Family Owners in a 1031 Exchange, *The New York Real Estate Weekly*, 2019

Special 1031 Exchanges: Get 360 Days to Complete, *The New York Real Estate Journal*, 2019

Section 1031: Who Can Be the Owner of your Replacement Property, *The New York Real Estate Weekly*, 2019

Qualifying Property in a 1031 Exchange: Understanding the Importance of Investment Intent, *The New York Real Estate Weekly*, 2018

What To Do About Closing Costs in a 1031 Exchange, *The New York Real Estate Weekly*, 2018

Partially Cashing Out in a 1031 Exchange-Will You Still Benefit?, *The New York Real Estate Journal*,

2018

Partnerships and 1031 Exchanges: Available Options for Partners and Partnerships, *New York Real Property Law Journal*, Summer/Fall 2015
Due Diligence When Recommending a QI, *The New York Real Estate Journal*, 2014
The Perfect Storm “Three Factors Driving the Surge in 1031 Exchange Activity in 2014”, *The New York Real Estate Journal*, 2014
What to Do About Expenses in a §1031 Exchange, *New York State Society of CPAs*, 2014
Understanding 201 Capital Gain Rates, *The New York Real Estate Journal*, 2013
The Importance of Fair Market rent in a 1031 Exchange, *Midatlantic Real Estate Journal*, 2013
Substantiating Investment Intent in a §1031 Exchange, *The New York Real Estate Journal*, 2011
Deferred But Not Forgotten, *The Mann Report*, 2008
Office Condos, Time Shares and Air Rights on the Rise, *The New York Real Estate Journal*, 2008
§1031 Investment Property or Not, *The Mann Report*, 2007
Combining Tax Strategies to Maximize Tax Benefits, *The Mann Report*, 2007
Depreciating Your §1031 Replacement Property, *The New York Real Estate Journal*, 2007
Does a Time Share Qualify for Deferral in a §1031 Exchange, *The Real Estate Weekly*, 2007
Getting Credits for Improvements to Replacement Property, *The Mann Report*, 2007
Selling your Hotel in a §1031 Exchange, *The Real Estate Weekly*, 2007
Tax Strategies for Selling Real Estate Owned by C Corporations, *The New York Real Estate Journal*, 2007 (Co-authored with David Stone, Stone Capital Advisors, LLC)
Treatment of Closing Costs in a §1031 Exchange, *The Northeast Business Journal*, 2007
Using the Auction Process to Maximize Value in a §1031 Exchange, *The Northeast Business Journal*, 2007 (Co-Authored with Misha Haghani, Esquire, Sheldon Good & Associates)
Can a Foreign Person Perform a §1031 Exchange, *The Mann Report*, 2006
Ensuring Timely Closings in a §1031 Exchange, *CIBS of Long Island Newsetter*, October, 2006
How to Buy Before You Sell in a §1031 Exchange, *The Mann Report*, 2006
Navigating the Murky Waters of a §1031 Exchange, *The Mann Report*, 2006
Restructuring Ownership in a §1031 Exchange, *The Mann Report*, 2006
Taking Back Paper May Create Havoc on Your §1031 Exchange, *The New York Real Estate Journal*, 2006

Lectures:

Pamela regularly lectures in house to law firms, CPAs and commercial brokerage firms and in public forums on behalf of various legal, accounting and real estate professional organizations in the Tri- State area and nationwide. Selected speaking engagements include:

June, 2016, Suffolk County Bar Association, Spring 2016
New York State Land Title Association, Spring 2016
New York State Society of CPAs, June, 2016
The Real Estate Board of New York, Regular Lecturer for Broker Training and Certification Courses, 2006- 2015.
CCIM- 2006-2014
TRIPLE PLAY NJ Realtor Convention, 2013
NYC Asset Management Roundtable, Presentation: The Power of Strategy™, 2006 and 2015
NYSSCPA – 2010 and Featured Speaker, Real Estate and Tax Committee, 2006
Coldwell Banker Commercial NJ, Multiple Presentations: Advanced §1031 Concepts, 2006 -2014
CIBS/ NYSCAR Joint Meeting- Roundtable Forum Speaker, 2008
ICSC Law and Accounting Conference Speaker, Like Kind Exchanges and Tenant in Common Programs, 2007
IMN Broker Dealer Conference, Panel Member, December, 2007
Lorman Education Services, Regular Lecturer Throughout Northeast, 2005, 2006 and 2007
UJA – Federation of NY, Speaker, Tax and Financial Planning Conference Convention, 2007

NYRS Certification Program Presenter, REBNY, 2007
NBI, Presenter, Like Kind Real Estate Exchanges, Saddlebrook, NJ, 2006
NYSCAR, Presenter, Annual Convention, 2006
ALTA 2005 Annual Convention, Speaker, Like Kind Exchanges, 2005
NY Real Estate Institute, Lecturer, 2005
SIOR, NJ Chapter, Presenter, December, 2004

Admitted to Practice:

Ohio, 1985
Florida, 1986

Education:

Ohio State University, J.D. - 1985
Kent State University, B.G.S.- 1982
The City of London, Finance, Banking and Investment – 1993;
Semester at Sea - Study/Travel program in the Middle East and Western Europe – 1981

1031 Tax Deferred Exchange Strategies

First Quarter, 2021

Presented by

**Pamela A. Michaels, Esq. – Senior Vice President
Asset Preservation, Inc. – A Stewart Subsidiary**

**David E. Thurston, Managing Director, The Thurston
Group**



**ASSET PRESERVATION
INCORPORATED**

Instructor: Pamela A. Michaels

- ▶ Senior Vice President of Asset Preservation, Inc. (API)
- ▶ Attorney Admitted in Multiple States since 1985
- ▶ NY Licensed Real Estate Broker
- ▶ Author of Numerous Articles on 1031 Exchanges and Related Topics
- ▶ Frequent Presenter/Educator to Attorneys, CPAs. Real Estate Agents and Related Organizations
- ▶ Approved Provider of NY/NJ CLE, CPE and CE credits
- ▶ API has facilitated over 175,000 exchanges
- ▶ 35 + years combined 1031 exchange/legal experience

Outline

- ▶ 1031 2021 First Quarter Summary
- ▶ Tax Code Provisions
- ▶ Capital Gain Taxes and other Tax Issues
- ▶ IRC Section 1031 Requirements
- ▶ The meaning of Hold For Investment
- ▶ Like-Kind Real Property and Creative Like-Kind Property Variations
- ▶ Exchange Entities
- ▶ Partnership Options
- ▶ The Exchange Equation
- ▶ Closing Costs
- ▶ Delayed Exchanges and Identification Rules
- ▶ Seller Financing
- ▶ G-6 Restrictions
- ▶ Parking Arrangements (Reverse & Improvement Exchanges)
- ▶ Split Treatment Transactions
- ▶ FIRPTA
- ▶ IRS Form 8824: Like-Kind Exchanges
- ▶ Qualified Intermediary (QI) Due Diligence

First Quarter 2021 1031 Update

- ▶ Increase capital gain taxes to ordinary income for high earners
- ▶ Increase tax rates to pre-TCJA levels
- ▶ Increase corporate tax rates from 21% to 28%
- ▶ Proposal to eliminate 1031 exchanges

First Quarter 2021 1031 Summary

- ▶ The Treasury provided tax relief to some investors with Notice 2020-23 which extended many deadlines for investors affected by the COVID-19 pandemic including Section 1031 exchange time deadlines.
- ▶ Notice 2020-23 extended the 45-day identification period deadline and 180-day exchange period for certain investors until July 15, 2020.
- ▶ In 2021, no further extensions in place currently

First Quarter 2021 1031 Update

- ▶ Exchanging out of downtown areas and into the suburbs.
- ▶ Less demand for tight multi-family property and more interest in SFRs outside the urban core.
- ▶ Big uptick in demand for property in rural areas or vacation destinations for those work from home. (East End of Long Island has seen 20%+ appreciation)
- ▶ States with good business climate and low taxes attracting more investors: TX, FL, TN, WY

First Quarter 2021 1031 Update

- ▶ Reverse exchanges are on the rise
- ▶ Investor taking advantage of favorable interest rates
- ▶ Investors see opportunities in certain marketplaces
- ▶ Investors seeking to reposition their assets
- ▶ Resort areas –most significant increase in prices and transactions
- ▶ Multi Family and Industrial –increased values
- ▶ Hotel, office and retail suffered from COVID

First Quarter 2021 1031 Summary

- ▶ On November 23, the Treasury released the final regulations (T.D. 9935) restricting like-kind exchanges to what is considered “real property” for Section 1031 exchange purposes after the enactment of Tax Cuts and Jobs Act (TCJA.) The final Treasury Regulations:
- ▶ Expanded the degree to which state and local law controls whether property should be classified as real property. Property is real property if A) it is classified as real property under state and local law (the “State Law” test) (B) is specifically listed as real property in the final regs (the “Listed Assets” test) and C) is considered real property based on all the facts and circumstances under the factors provided in the final regs (the “Factors” test).
- ▶ Eliminated the proposed regs purpose or use test under which the function of a property was considered for determining with the property was real for Section 1031 purposes.

Capital Gain Taxation

- ▶ 20% capital gain tax rate for high earners
- ▶ 3.8% “Net investment income tax” (NIIT) pursuant to IRC Section 1411
- ▶ Capital gain taxation includes 5 components:
 - 1) Taxation on depreciation recapture at 25% - *plus*
 - 2) Federal capital gain taxes at 20% (or 15%) - *plus*
 - 3) 3.8% tax on net investment income - *plus*
 - 4) The applicable state tax rate (0% - 13.3%)
 - 5) The applicable local tax rate (NYC)

Capital Gain Taxes in 2021

- ▶ Taxpayers owe federal capital gain taxes on their economic gain depending upon their taxable income.
- ▶ A 20% capital gain tax applies to single filers exceeding \$441,550 in taxable income and married couples filing jointly with over \$496,600 in taxable income. Thresholds may change in 2021.
- ▶ The capital gain tax rate of 15% remains for taxpayers below these threshold income amounts.

3.8% Net Investment Income Tax (IRC §1411)

- ▶ The Health Care and Education Reconciliation Act of 2010 added a 3.8% on “net investment income” (NIIT).
- ▶ This 3.8% tax applies to taxpayers with “net investment income” who exceed threshold income amounts of \$200,000 for single filers and \$250,000 for married couples filing jointly.
- ▶ Pursuant to IRC Section 1411, “net investment income” includes interest, dividends, **capital gains**, retirement income and income from partnerships (as well as other forms of “unearned income”).

The Code

H.R. 1 (the “Tax Cuts and Jobs Act”)

Section 13303 of the Senate amendment revised Section 1031(a)(1) of the Code to provide that:

*“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.”*

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

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)



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.

▶ Real Property Definition Can be Broad

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.”

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.

Cooperatives (Co-ops)

- ▶ The IRS has consistently ruled that a New York co-op is like kind to real estate, even though ownership is held in the form of stock in a corporation.
- ▶ In PLR 200631012, the IRS approved a proposed exchange of co-op stock for real property and improvements to be acquired by family members and family owned entities. [See, e.g., Rev. Rul. 55-749, 1955-2 C.B. 295.]
- ▶ Various New York statutes treat an interest in a cooperative as equivalent to an interest in real property. [N.Y. Civ. Prac. L.& R. §5206(a)]
- ▶ Homestead exemption [N.Y. Real Prop. Law § 279(5) (McKinney 1989)]
- ▶ Mortgage for cooperation interest [N.Y. Pub. Auth. Law § 2402(5) (McKinney Supp. 2006)]
- ▶ Real property tax for senior citizens [N.Y. Real Prop. Tax Law § 467(3-a) (McKinney Supp. 2006)]
- ▶ Mansion tax [N.Y. Tax Law § 1402-a(a) (McKinney 2004)]

Leaseholds

- ▶ A leasehold interest with a remaining term of 30 years or more is considered like-kind property to a fee interest.
- ▶ If the leasehold interest is less than 30 years but provides for optional renewal periods, these renewal periods can be included in determining if the leasehold interest has 30 years or more remaining.
- ▶ In one case, a leasehold interest with an initial term of 5 years and 10 optional renewal periods of 5 years each was held to be like-kind property since the taxpayer had the right to use the property for up to 55 years.
[R&J Furniture Co. v. Comm., 20 T.C. 857 (1953)]

REIT Shares: Do Not Qualify for Section 1031

- ▶ A share in a REIT (Real Estate Investment Trust) is excluded from 1031 exchange deferral.
- ▶ A share in a REIT is a personal property interest and therefore does not qualify as real property for Section 1031.
- ▶ Many REITS, at the entity level, perform 1031 exchanges on assets owned by the REIT. REITs are required to distribute most of their cash at year end so they have an incentive to redeploy capital into better performing assets via Section 1031 versus holding cash on their books.
- ▶ However, there is a creative approach for taxpayers, in certain situations, to do a 1031 exchange into a DST and later essentially end up with the economic equivalent of REIT shares if they are willing to contemplate several steps over time using several IRC tax sections.

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.

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.

§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.
- ▶ 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.

§1031 - Partnership Issues

- ▶ Both drops and swaps and swaps and drops present separate challenges
- ▶ Drop and Swap Challenges Include:
 1. Holding Period
 2. Creation of Legal Tenant In Common Arrangement
 3. Changing Business Conduct to Reflect TICs
 4. Practical Considerations: Promotes, Management Agreement
 5. Possible violation of loan covenants
 6. Whether Sole Asset Owned by Partnership

§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

- ▶ Swap and Drop Challenges Include
 1. Identification of Replacement Property
 2. Holding Period Post Acquisition
 3. Distribution in manner which satisfies a pro-rata distribution of partnership assets
 4. Practical considerations: Partners remain together for period
 5. Lender Consent if any

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	\$5,000,000
- Debt	\$2,500,000
- Cost of Sale	\$300,000
Net Equity	\$2,200,000

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	\$5,000,000	\$5,200,000
- Debt	\$2,500,000	3,000,000
- Cost of Sale	\$300,000	
Net Equity	\$2,200,000	\$2,200,000

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	\$5,000,000	\$5,200,000	
- Debt	\$2,500,000	3,000,000	\$ 0
- Cost of Sale	\$300,000		
Net Equity	\$2,200,000	\$2,200,000	\$ 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	\$5,000,000	\$3,000,000	
- Debt	\$2,500,000	\$2,000,000	\$ 500,000
- Cost of Sale	\$300,000		
Net Equity	\$2,200,000	\$1,000,000	\$ 1,200,000
Total Boot			\$ 1,700,000

The taxpayer acquired property of a lower value, keeps \$1,200,000 of the net equity and acquired a replacement property with \$500,000 less debt.

Analysis: This results in a total of \$1,700,000 in boot.
(\$500,000 mortgage boot and \$1,200,000 in cash boot = \$1,700,000)

Closing Costs

Exchange Expenses:

Transfer taxes, real estate agent/broker commissions, attorney fees, recording fees, qualified intermediary fees, title insurance fees

Will not generate boot

Transactional Costs:

1.1031(k)-1(g)(7) defines

Examples: real estate taxes, rents and other pro-rations

May generate boot

Seller Financing in a 1031

- ▶ Will likely result in a partial exchange unless note can be included in the exchange.
- ▶ If 1031 contemplated best to require buyer to obtain 3rd party financing
- ▶ Portion being seller financed taxed on the installment basis under IRC Section 453.
- ▶ Only balance of value (equity and debt) available to include in exchange.
- ▶ Exception: note is made payable to Qualified intermediary.

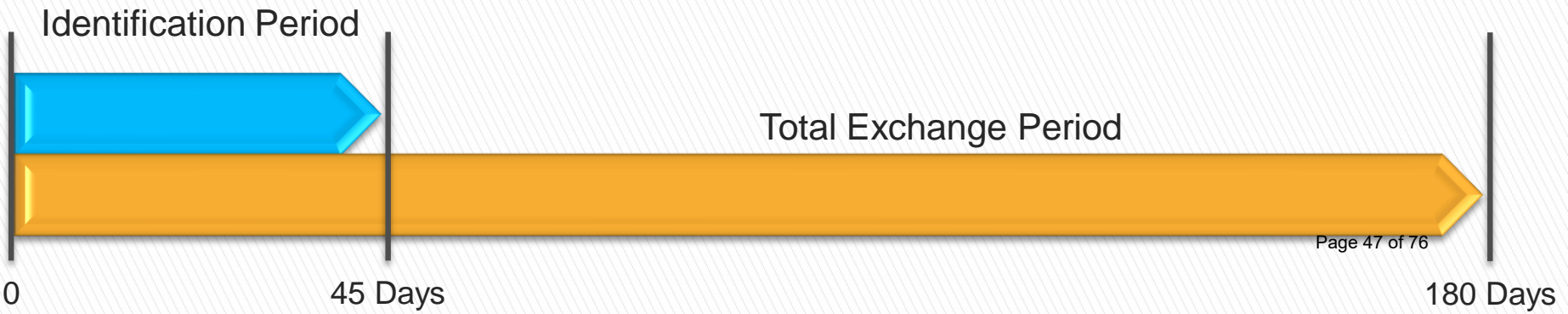
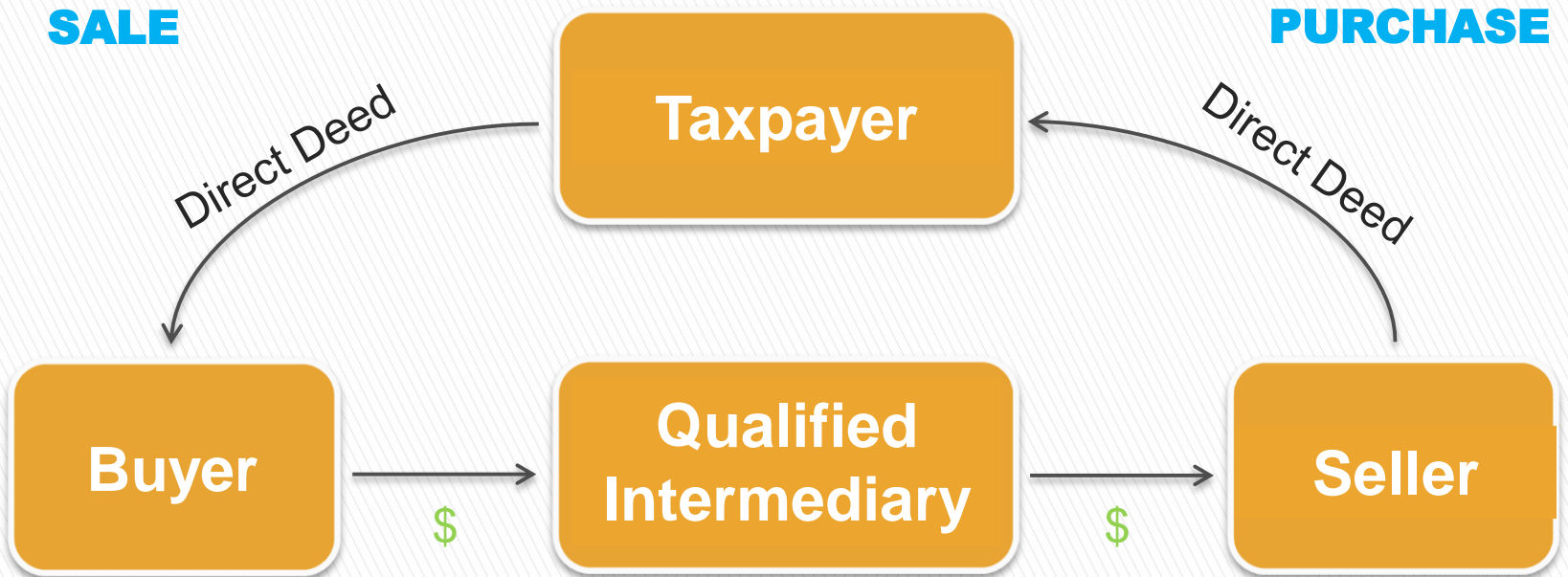
Seller Financing in a 1031

- ▶ If the note made payable to Qualified Intermediary at closing
 1. Seller can purchase all or part of note with separate funds prior to purchasing replacement property within the exchange period.
 2. Third party can purchase note in same time as noted above.
 3. The note may be used as payment for the purchase of replacement property. In this scenario, the note is assigned to the seller by the QI and delivered to the seller at closing.
 4. The payer on the note can pay off the note prior to closing on the replacement property. The note is actually paid off during the exchange. This works only on short-term notes due within the 180 day exchange period. The payer pays off the note directly to the Intermediary, the holder of the note.

Partial Exchanges

- ▶ Where exchanger intends at the closing of the sale of relinquished property to pocket part of the cash
- ▶ The amount excluded paid directly to the exchanger at closing
- ▶ Taxable boot subject to offsets
- ▶ Must specify before closing or pursuant to G-6 must be held by QI until end of the exchange
- ▶ If uncertain whether to include in exchange, include as otherwise will need to apply after tax dollars to purchase

The Delayed Exchange



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

G-6 Restrictions

- ▶ Dictate when 1031 funds can be released to exchanger once sale of relinquished property closed
- ▶ Funds can be released at the end of the exchange
- ▶ Exchange ends:
 - 45 calendar days after the closing of the sale if no replacement property identified
 - If identified exchange does not end until all identified property purchased, tax return is due or filed or the 180th day
 - Exception: Material and Substantial Contingency

Restrictions on Exchange Proceeds



In a deferred exchange, U.S. Treasury Regulations, Section 1.1031 (k)-1(g)(6), require stipulations in the exchange agreement which limit the Taxpayer's ability to receive, pledge, borrow or otherwise obtain the benefits of money or other property before the end of the exchange period. The Exchanger may have rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property upon or after:

Restrictions on Exchange Proceeds



(a) The receipt by the Taxpayer of all replacement property to which the taxpayer is entitled under the exchange agreement

(b) The occurrence after the end of the identification period of a material and substantial contingency that —

(1) Relates to the deferred exchange,

(2) Is provided for in writing, and

(3) Is beyond the control of the Taxpayer and of any disqualified person (as defined in paragraph (K) of this section), other than the person obligated to transfer the replacement property to the taxpayer.”

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.

The Reverse Exchange

Parking the Replacement Property

POSITIVES:

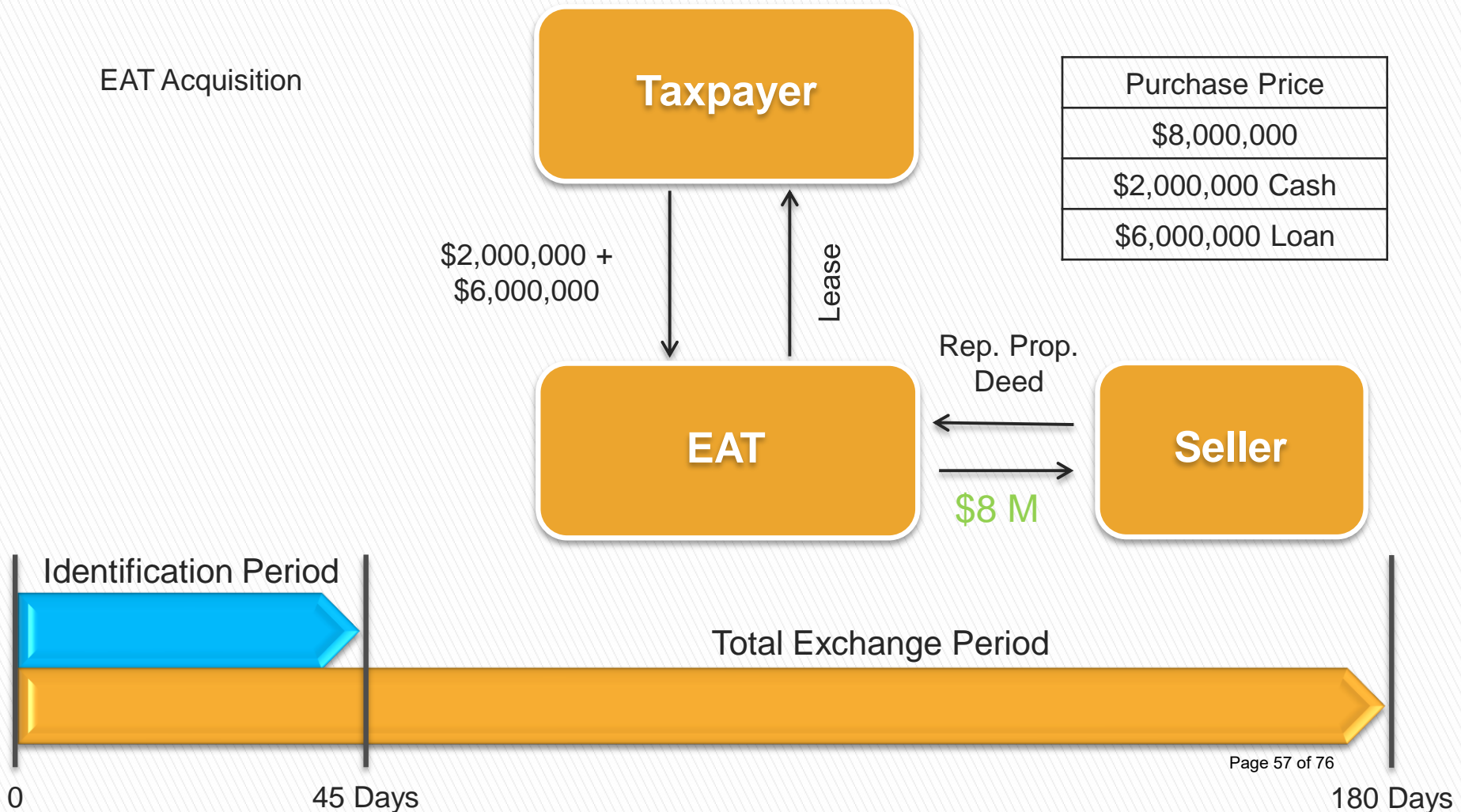
- ▶ Exchange equity does not need to be present
- ▶ Allows for multiple relinquished properties

NEGATIVES:

- ▶ Lender may have issues lending to the EAT

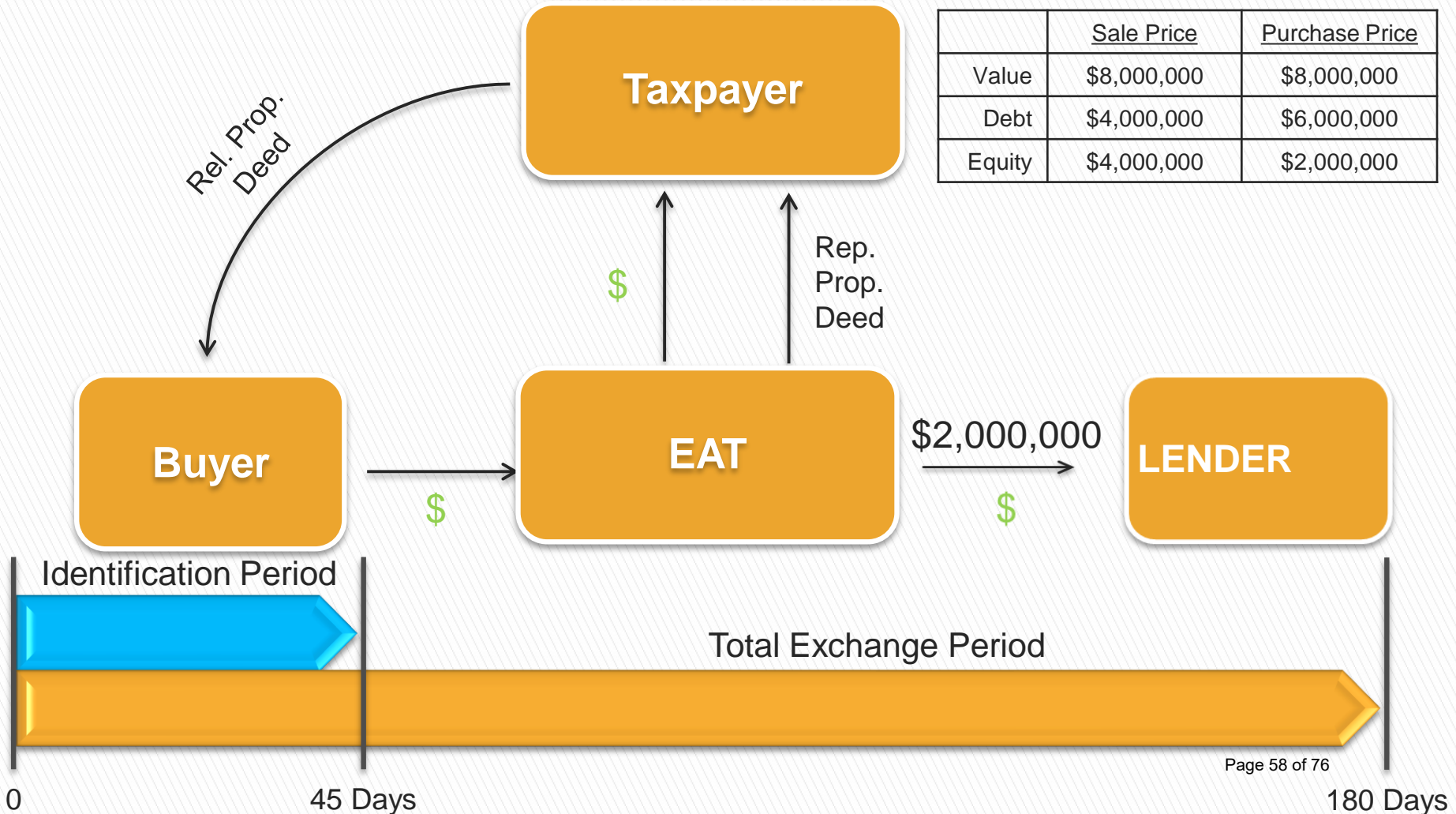
Reverse Exchange Format

Replacement Property Parked - Step 1



Reverse Exchange Format

Replacement Property Parked - Step 2



Reverse Exchange Format

Replacement Property Parked - Step 3

Prior to transferring title to replacement property to exchanger, \$2 million of the sale proceeds must be used to pay down the loan on the replacement property to achieve full deferral.

	<u>Sale Price</u>	<u>Purchase Price</u>
Value	\$8,000,000	\$8,000,000
Debt	\$4,000,000	\$6,000,000 Less \$2,000,000 paydown= \$4,000,000
Equity	\$4,000,000	\$2,000,000 +\$2,000,000 additional equity =\$4,000,000

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.

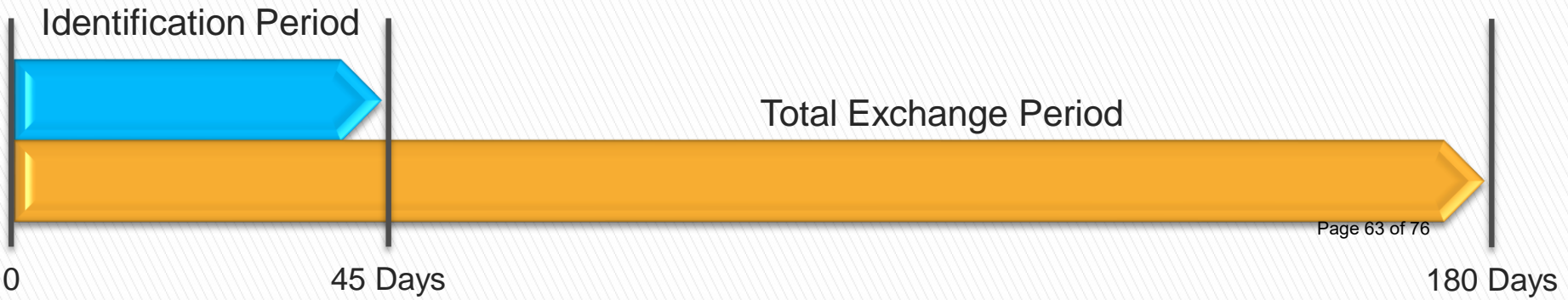
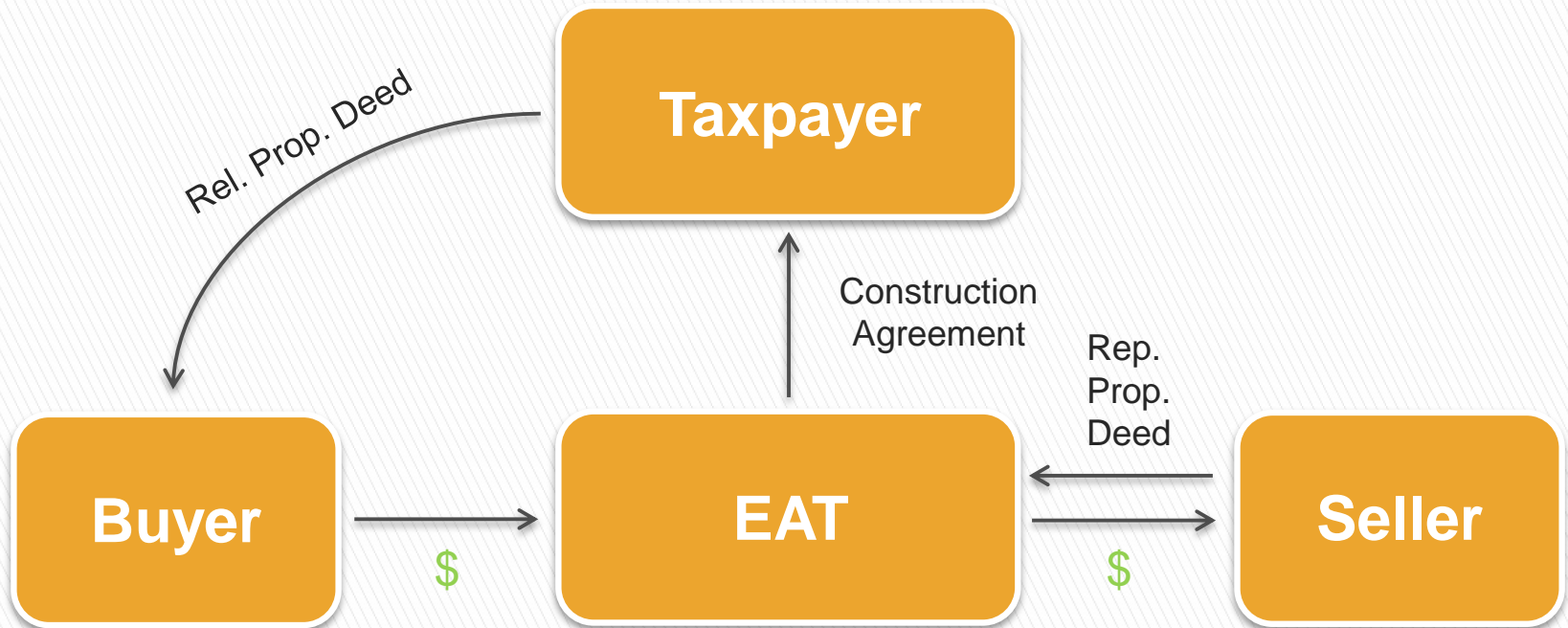
The Improvement Exchange

ID of Replacement Property to be Produced



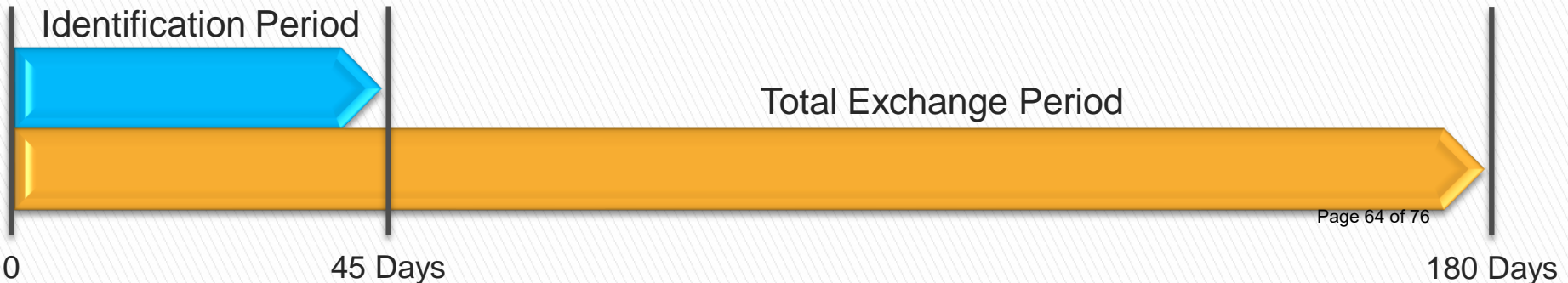
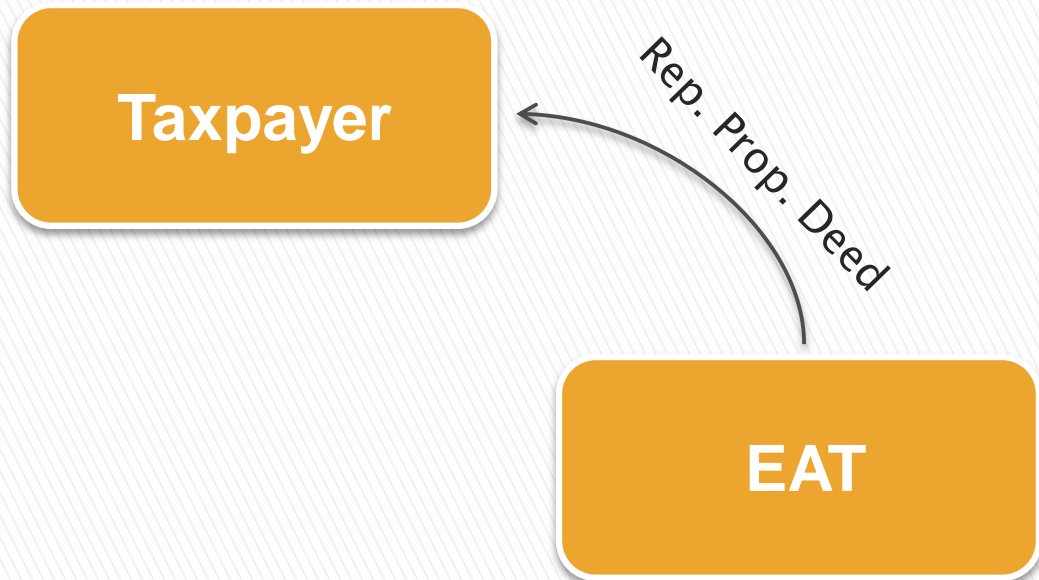
...if a legal description is provided for the underlying land and as much detail is provided regarding construction of the improvements as is practicable at the time identification is made.”

The Improvement Exchange



The Improvement Exchange

STEP 2



The Improvement Exchange

How do the numbers work out?

Relinquished Property

Sales Price	\$5,000,000
-------------	-------------

Debt	\$0
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Cost of Sale	\$300,000
--------------	-----------

Net Equity to QI	\$4,700,000
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Replacement Property

Lot Purchase (cash)	\$3,000,000
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Draw 1 site work	\$1,200,000
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Draw 2 foundation	\$500,000
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Exchange Value	\$4,700,000
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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 filing single and \$500,000 if married filing jointly.
- ▶ Tax exclusion up to the threshold amounts

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 Fourplex

3 units rented (§1031)

1 unit used as a principal residence (§121)



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 requirement 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 under §121 and tax deferral under §1031.

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.
- ▶ 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 rented.
- ▶ Depreciation recapture taken during the time used in a business or held for investment is not excluded .

Foreign Exchanger/Seller

- ▶ **Simultaneous Exchange with no Boot:** Withholding is not required. Taxpayer must provide the Qualified Intermediary and the buyer with a FIRPTA Notice of Non-Recognition Transfer prior to closing.
- ▶ **Delayed Exchanges:** Apply for Withholding Certificate from the IRS to reduce or eliminate the required amount of withholding (15% for dispositions after February 17, 2016).
- ▶ For more information on FIRPTA, visit: www.irs.gov and download **IRS Publication 515: Withholding of Tax on Nonresident Aliens and Foreign Entities**.

IRS Form 8824

Form **8824** Like-Kind Exchanges
(and section 1043 conflict-of-interest sales)

OMB No. 1545-1190
2014
Attachment
Sequence No. **109**

Department of the Treasury
Internal Revenue Service

► Attach to your tax return.
► Information about Form 8824 and its separate instructions is at www.irs.gov/form8824.

Name(s) shown on tax return Identifying number

Part I Information on the Like-Kind Exchange

- Note:** If the property described on line 1 or line 2 is real or personal property located outside the United States, indicate the country.
- 1 Description of like-kind property given up: _____
- 2 Description of like-kind property received: _____
- 3 Date like-kind property given up was originally acquired (month, day, year) **3** MM/DD/YYYY
- 4 Date you actually transferred your property to other party (month, day, year) **4** MM/DD/YYYY
- 5 Date like-kind property you received was identified by written notice to another party (month, day, year). See instructions for 45-day written identification requirement **5** MM/DD/YYYY
- 6 Date you actually received the like-kind property from other party (month, day, year). See instructions **6** MM/DD/YYYY
- 7 Was the exchange of the property given up or received made with a related party, either directly or indirectly (such as through an intermediary)? See instructions. If "Yes," complete Part II. If "No," go to Part III Yes No

Part II Related Party Exchange Information

8 Name of related party Relationship to you Related party's identifying number

Address (po, street, and apt., room, or state no., city or town, state, and ZIP code)

- 9 During this tax year (and before the date that is 2 years after the last transfer of property that was part of the exchange), did the related party sell or dispose of any part of the like-kind property received from you (or an intermediary) in the exchange or transfer property into the exchange, directly or indirectly (such as through an intermediary), that became your replacement property? Yes No
- 10 During this tax year (and before the date that is 2 years after the last transfer of property that was part of the exchange), did you sell or dispose of any part of the like-kind property you received? Yes No

If both lines 9 and 10 are "No" and this is the year of the exchange, go to Part III. If both lines 9 and 10 are "No" and this is not the year of the exchange, stop here. If either line 9 or line 10 is "Yes," complete Part III and report on this year's tax return the deferred gain or (loss) from line 24 unless one of the exceptions on line 11 applies.

- 11 If one of the exceptions below applies to the disposition, check the applicable box:
- a The disposition was after the death of either of the related parties.
- b The disposition was an involuntary conversion, and the threat of conversion occurred after the exchange.
- c You can establish to the satisfaction of the IRS that neither the exchange nor the disposition had tax avoidance as one of its principal purposes. If this box is checked, attach an explanation (see instructions).

Part III Realized Gain or (Loss), Recognized Gain, and Basis of Like-Kind Property Received

- Caution:** If you transferred and received (a) more than one group of like-kind properties or (b) cash or other (not like-kind) property, see Reporting of multi-asset exchanges in the instructions.
- Note:** Complete lines 12 through 14 only if you gave up property that was not like-kind. Otherwise, go to line 15.
- 12 Fair market value (FMV) of other property given up **12**
- 13 Adjusted basis of other property given up **13**
- 14 Gain or (loss) recognized on other property given up. Subtract line 13 from line 12. Report the gain or (loss) in the same manner as if the exchange had been a sale **14**
- Caution:** If the property given up was used previously or partly as a home, see Property used as home in the instructions.
- 15 Cash received, FMV of other property received, plus net liabilities assumed by other party, reduced (but not below zero) by any exchange expenses you incurred (see instructions) **15**
- 16 FMV of like-kind property you received **16**
- 17 Add lines 15 and 16 **17**
- 18 Adjusted basis of like-kind property you gave up, net amounts paid to other party, plus any exchange expenses not used on line 15 (see instructions) **18**
- 19 **Realized gain or (loss).** Subtract line 18 from line 17 **19**
- 20 Enter the smaller of line 15 or line 19, but not less than zero **20**
- 21 Ordinary income under recapture rules. Enter here and on Form 4797, line 16 (see instructions) **21**
- 22 Subtract line 21 from line 20. If zero or less, enter -0-. If more than zero, enter here and on Schedule D or Form 4797, unless the installment method applies (see instructions) **22**
- 23 **Recognized gain.** Add lines 21 and 22 **23**
- 24 Deferred gain or (loss). Subtract line 23 from line 19. If a related party exchange, see instructions **24**
- 25 **Basis of like-kind property received.** Subtract line 15 from the sum of lines 18 and 23 **25**

Part IV Deferral of Gain From Section 1043 Conflict-of-Interest Sales

- Note:** This part is to be used only by officers or employees of the executive branch of the Federal Government or judicial officers of the Federal Government (including certain spouses, minor or dependent children, and trustees as described in section 1043) for reporting nonrecognition of gain under section 1043 on the sale of property to comply with the conflict-of-interest requirements. This part can be used only if the cost of the replacement property is more than the basis of the divested property.
- 26 Enter the number from the upper right corner of your certificate of divestiture. (Do not attach a copy of your certificate. Keep the certificate with your records.) **26** -
- 27 Description of divested property ► _____
- 28 Description of replacement property ► _____
- 29 Date divested property was sold (month, day, year) **29** MM/DD/YYYY
- 30 Sales price of divested property (see instructions). **30**
- 31 Basis of divested property **31**
- 32 **Realized gain.** Subtract line 31 from line 30 **32**
- 33 Cost of replacement property purchased within 60 days after date of sale **33**
- 34 Subtract line 33 from line 30. If zero or less, enter -0- **34**
- 35 Ordinary income under recapture rules. Enter here and on Form 4797, line 10 (see instructions) **35**
- 36 Subtract line 35 from line 34. If zero or less, enter -0-. If more than zero, enter here and on Schedule D or Form 4797 (see instructions) **36**
- 37 **Deferred gain.** Subtract the sum of lines 35 and 36 from line 32 **37**
- 38 **Basis of replacement property.** Subtract line 37 from line 33 **38**

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).
- ▶ Does the QI provide depository options?
- ▶ Does the QI provide written backing from a large creditworthy entity?

QI Due Diligence

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

Contact Asset Preservation

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