Section 1031 Like-Kind Exchanges – Current Strategies for Land Investors

Chet A. Mellema, JD, CES
Exchange Officer

IPE 1031 QUALIFIED INTERMEDIARY SERVICES

www.IPE1031.com

About IPE 1031

Meet Our Professionals

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A graduate of the University of Iowa College of Business and Drake University Law School, Dave is a member of the Iowa State Bar Association and served as a past Chair of its Tax Committee; the Iowa Commercial Real Estate Association; and the Realtor's Land Institute. Dave serves on the Federation of Exchange Accommodators Government Affairs Committee. He previously served on its Board of Directors, as Chair of its Ethics Committee, and as its 2013 President. He holds the designation of Certified Exchange Specialist ("CES®") and lectures on the subject of Section 1031 for events sponsored by the Iowa State Bar Association, Drake University Law School, the University of Iowa College of Law, the University of Nebraska, the Realtors Land Institute, the Iowa Association of Realtors, and various other accounting, legal and real estate associations. Dave is a contributing editor to the Iowa State Bar Association Income Tax Manual.

M. Kathleen Brown *Vice President*

Katie received her undergraduate degree from Saint Mary's College, Notre Dame, Indiana and her law degree, with honors, from Drake University Law School in 1999, where she was a Note Editor for the *Drake Law Review*. She is a member of the Iowa State Bar Association, the Federation of Exchange Accommodators, the Iowa Commercial Realtors Association and the Realtor's Land Institute. Prior to joining IPE 1031 in 2007, she practiced law as a partner with a private law firm. Katie holds the designation of Certified Exchange Specialist ("CES®").

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Becky received her law degree, with honors, from Creighton University and served on the *Creighton Law Review*. Becky holds a bachelor's degree in finance from the University of Northern Iowa. Prior to joining IPE 1031 in 2011, she served as Field Operations Director and Commercial Underwriting Counsel for Iowa's Title Guaranty program and managed escrow operations for Title Guaranty's Commercial Services Department. Becky is a member of the Iowa Commercial Real Estate Association; the Realtor's Land Institute; the Iowa State Bar Association, where she previously served on the Real Estate Section Council; and the Federation of Exchange Accommodators. She holds the designation of Certified Exchange Specialist ("CES®") and regularly lectures on the subject of Section 1031 for accounting, legal and real estate associations. Becky is also President of IPE Closing & Escrow.

Chet A. Mellema *Exchange Officer*

Chet received his juris doctor from the University of Iowa College of Law, where he served as a student writer and Note & Comment Editor for the *Journal of Corporation Law*. Chet also holds a bachelor's degree in finance from Drake University and a Business Leadership Certificate from Drake's College of Business and Public Administration. Chet is a member of the Iowa State Bar Association, serving several terms on the Real Estate & Title Section Council; the American Bar Association; Iowa Commercial Real Estate Association; and the Federation of Exchange Accommodators. He brings over 20 years of private practice and corporate legal experience to IPE 1031, with concentrations in real estate, business and debtor/creditor law. Chet is a contributing editor to the Iowa State Bar Association Income Tax Manual, holds the designation of Certified Exchange Specialist ("CES®"), and regularly speaks on the topic of Section 1031 for realtors, accountants, attorneys and similar professionals.

DELAYED EXCHANGES
REVERSE EXCHANGES ▾ IMPROVEMENT EXCHANGES

I.R.C. Section 1031 Reference Guide

I.R.C. § 1031 REFERENCE GUIDE

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I.R.C. § 1031 PURPOSE:

Section 1031 allows owners of business and investment real property to defer payment of capital gains taxes by reinvesting proceeds from the sale of a currently owned property (relinquished property) into new like-kind property (replacement property).

TYPES OF EXCHANGES:

Delayed: A delayed exchange occurs when a taxpayer, utilizing the services of a qualified intermediary, first sells relinquished property and subsequently acquires replacement property. Subject to certain rules, the taxpayer has up to 180 days from the transfer of the relinquished property to acquire replacement property.

Reverse: A reverse exchange occurs when a taxpayer, utilizing the services of a qualified intermediary and an exchange accommodation titleholder (EAT), acquires replacement property before disposing of relinquished property. In a reverse exchange, Section 1031 requires that the EAT take actual title to the replacement property until the relinquished property is sold. A reverse exchange benefits a taxpayer when the taxpayer must purchase the replacement property before being able to sell relinquished property, or a taxpayer wants to ease time pressures associated with identification deadlines in a delayed exchange. To fall within the safe harbor of Section 1031, the transaction must be completed within the 180-day time period.

Improvement: Taxpayers who desire to construct improvements on replacement property, utilizing relinquished property proceeds on deposit with a qualified intermediary, can do so by structuring the transaction as an improvement exchange. Improvement exchanges are similar to reverse exchanges in that an EAT must take actual title to the replacement property while it is under construction. To fall within the safe harbor of Section 1031, the transaction must be completed within the 180-day time period.

QUALIFYING PROPERTY:

Real Property: Generally speaking, nearly all types of real estate are classified as like-kind to each other. So long as a piece of real property is used for investment or for use in a business, it will qualify for Section 1031 treatment. Examples of real properties that can be exchanged for one another include the following: rental properties, farms and ranches, office buildings, motels and hotels, golf courses, raw land, industrial properties, retail properties, storage units, vacation homes with certain limitations, leasehold interests of 30 years or longer in length, and certain other partial interests in real property.

As of January 1, 2018, personal property can no longer be exchanged.

1031 EXCHANGE

Top Ten Exchange Red Flags

TOP TEN EXCHANGE RED FLAGS

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1. **The Disqualified Qualified Intermediary:** To effectuate a deferred Section 1031 exchange, taxpayers must utilize the qualified intermediary safe harbor. Any person serving as a qualified intermediary for the taxpayer cannot be a disqualified party. Examples of disqualified parties include the taxpayer's attorneys, accountants, real estate agents/brokers and employees. Under the Internal Revenue Code's attribution rules, the disqualification cannot be removed by setting up a separate legal entity owned by the disqualified party or by a disqualified party's family member. Taxpayers seeking the services of a qualified intermediary company should inquire into the entity's ownership to ensure the exchange will not be disqualified as a result of its ownership.

2. **Not Asking the Right Questions:** While most exchangers and practitioners appreciate the complexities of Section 1031, some hold the opinion that most exchanges are "plain vanilla." Rarely is this the case. By asking the right questions from the start, a seasoned qualified intermediary can uncover problems and offer alternative structures. Planning and careful consultation with the qualified intermediary, as well as tax and legal advisors, is the key to a successful exchange transaction.

3. **Unassignable Real Estate Purchase Agreements:** While it is common practice to place exchange cooperation language in purchase agreements, a critical component of the language is often omitted. Under Section 1031, the exchanging taxpayer must have the ability to assign the agreement to the qualified intermediary. It is crucial to review agreements for the ability to assign, or to amend contractual language to state that the agreement may be assigned by the exchanging taxpayer.

4. **Trading Down in Value:** It is a common misconception that an exchanger can defer all tax on the sale of a relinquished property by simply reinvesting gain on the sale. Generally speaking, to defer all tax on an exchange transaction, three general rules must be satisfied. First, the value of the replacement property must be greater than or equal to the value of the relinquished property. Second, all equity from the relinquished property must be reinvested into the replacement property. Third, all debt relief from the relinquished property sale must be replaced with equivalent new debt on the replacement property; or in the alternative, new cash can be substituted for debt relief. While gain on an exchange can be partially deferred, tax will result to the extent a trade down in replacement property value occurs. Exchangers are encouraged to consult with their tax advisors regarding other tax matters that may impact the ability to defer taxes in a Section 1031 exchange.

5. **Not Utilizing the Power of Reverse Exchanges:** A reverse exchange transaction may be appropriate when a taxpayer desires to take title to a replacement property prior to conveying the relinquished property. Revenue Procedure 2000-37 provides a safe harbor for these situations. To accommodate a reverse exchange, title may be parked with an Exchange Accommodation Titleholder. A reverse exchange can afford an exchanging taxpayer with the ability to locate and acquire the most suitable property with reduced time pressures. Commonly, a taxpayer can utilize a reverse exchange to achieve significant savings on the purchase of the replacement property.

1031 EXCHANGE

2025: Capital Gains Tax Rates

- Gain due to appreciation:
  - 0% up to $48,350 (single) $96,700 (married)
  - 15% up to $533,400 (single) $600,050 (married)
  - 20% for earnings over $533,400 (single) $600,050 (married)
  - 3.8% Net Investment Income Tax for earners over $200,000 (single) $250,000 (married)
- Gain due to depreciation (25% or ordinary income, depending on asset type)
- State capital gains: Ranges between 4-6% for most states in, or near, the Midwest
- Gain on properties held less than one year (ordinary income)

30%+ potential long term capital gain tax for income over $533,400/$600,050

Four Options with a Property

1. Hold
2. Cash Out
3. Installment Sale
4. 1031 Exchange

Reasons to Hold

- Strong asset (cash flow, future appreciation)
- Favorable existing financing
- Simply don’t want to pay tax
- Estate planning - stepped up basis for heirs

Reasons to Cash Out

- Reduce debt
- Low capital gains tax rates
- Diversify into different asset classes
- Start a 1031 exchange but can't find suitably priced replacement property

BASIS

- Cost of a property for tax purposes
- If purchased outright, basis is the price paid for the property plus acquisition costs
- Capital improvements increase basis
- Items that provide a tax benefit decrease basis, *e.g.* cost recovery (depreciation)

Installment Sale –
Receive Payments Over Time

GAIN CALCULATION:

$ 1,000,000	Sale Price of Property (2025)
- 200,000	Basis of Property (2010 Purchase)
800,000	Gain (Tax @ 30% = $240,000)

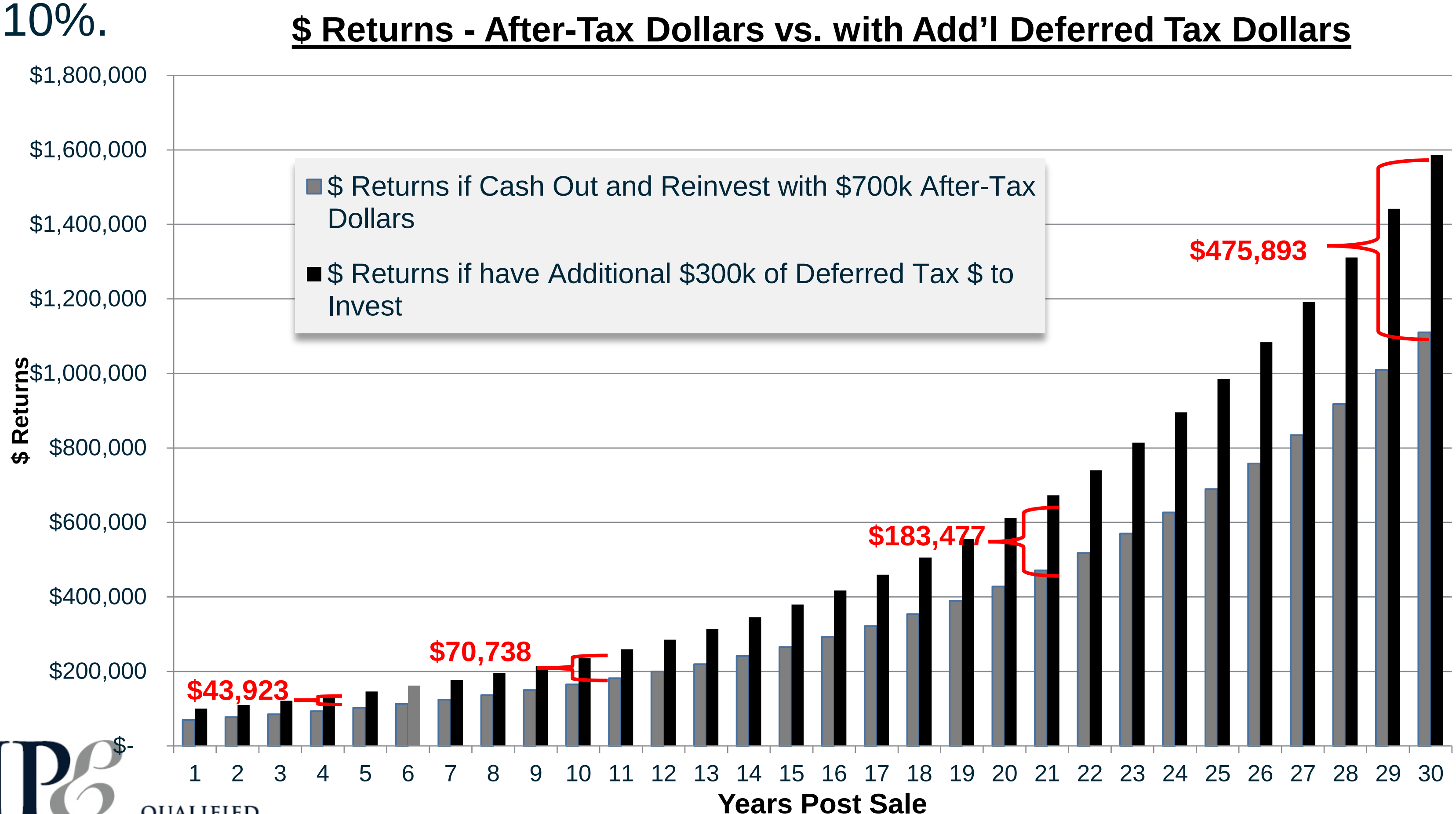
Year Taxed	Funds Received	Basis	Amount Taxed	Tax
2025 (15% Fed / 5% State)	$200,000	$40,000	$160,000	$32,000
2026 (20%)	$200,000	$40,000	$160,000	$32,000
2027 (20%)	$200,000	$40,000	$160,000	$32,000
2028 (20%)	$200,000	$40,000	$160,000	$32,000
2029 (20%)	$200,000	$40,000	$160,000	$32,000
Total	**$1,000,000**	**$200,000**	**$800,000**	**$160,000**

Sale of Property With $1,000,000 Gain

TAX CALCULATION (No Basis):		
Federal Capital Gains Tax:	$200,000	($1,000,000 x 20%)
Net Investment Income Tax:	$ 38,000	($1,000,000 x 3.8%)
State Capital Gains Tax:	$ 62,000	($1,000,000 x 6.0%)
Total Tax Paid:	**$300,000**	
Funds After Tax:	$700,000	v. $1,000,000

1031 Exchange Illustration

Sale of 160 acre parcel of land for $1.5M with a $500k basis. Assumed tax rate on $1M gain is 30%. Assumed annual return from reinvestment is 10%.



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1031 Exchange for Real Property Only

Section 1031 applies to real property only.

Examples:

- 80 acres of bare ground exchanged for 80 acres of bare ground closer to home.
- 80 acres of bare ground exchanged for an apartment building, retail center, vacation home (limited circumstances), or other real property held for investment or used in a trade or business.
- Office building exchanged for a farm.

Qualifying Like-Kind Properties Include:

- Rental properties (houses, duplexes, apartment complexes, etc.)
- Farms and farm land (except homestead)
- Office buildings
- Retail spaces (strip malls, stand alone stores, gas stations, etc.)
- Industrial and warehouse facilities
- Mini-storage units
- Raw land (land held for appreciation)
- Golf courses and sporting complexes
- Vacation homes – <u>under very limited circumstances</u>
- Partial Interests – TIC %, permanent conservation easements, leases (30 years or more), contract rights, remainder interests

Agricultural Properties :

- Farms and farm land (except homestead)
- Partial interests – tenant-in-common percentage, remainder interests, contract rights
- Special purpose agricultural: hog buildings, grain bins, fence and tile
- Water rights – perpetual in duration
- Conservation easements - permanent
- Timber rights
- Roads, pipelines and power lines: Section 1033 when under threat of condemnation. Two year replacement period for similar use properties.
- Wind turbine and cell tower leases

Red Flag: Trading Down in Value

To defer <u>all</u> capital gain:

1. The replacement property must have a value that is equal to or greater than the sale price of the relinquished property.

2. The exchanger must place all of the equity from the sale of their relinquished property into the replacement property.

3. The replacement property must have debt that is equal to or greater than that of the relinquished property.

Red Flag: Trading Down in Value

	Relinquished Property	Replacement Property
Sale Price:	$1,000,000	$ 1,000,000
Debt:	$ 500,000	$ 500,000
Equity:	$ 500,000	$ 500,000

If replacement property value is greater than or equal to the relinquished property then all tax can be deferred.

Red Flag: Trading Down in Value

	Relinquished Property	Replacement Property
Sale Price:	$1,000,000	$ 800,000
Debt:	$ 500,000	$ 300,000
Equity:	$ 500,000	$ 500,000

If the taxpayer "trades down" in sale price, debt, or equity, he/she will be taxed on the amount of the "trade down" up to their realized gain.

Receipt of Cash Always Taxable

	Relinquished Property	Replacement Property
Sale Price:	$1,000,000	$1,200,000
Debt:	$ 500,000	$ 800,000
Equity:	$ 500,000	$ 400,000

The exchanger acquired replacement property worth $200,000 more than the value of relinquished property and received $100,000 cash from the exchange. Cash is not like-kind to real estate. Mortgage debt incurred does not offset cash boot received. The exchanger will pay tax on $100,000.

Option: Pre- and post-exchange refinancing (pros and cons)

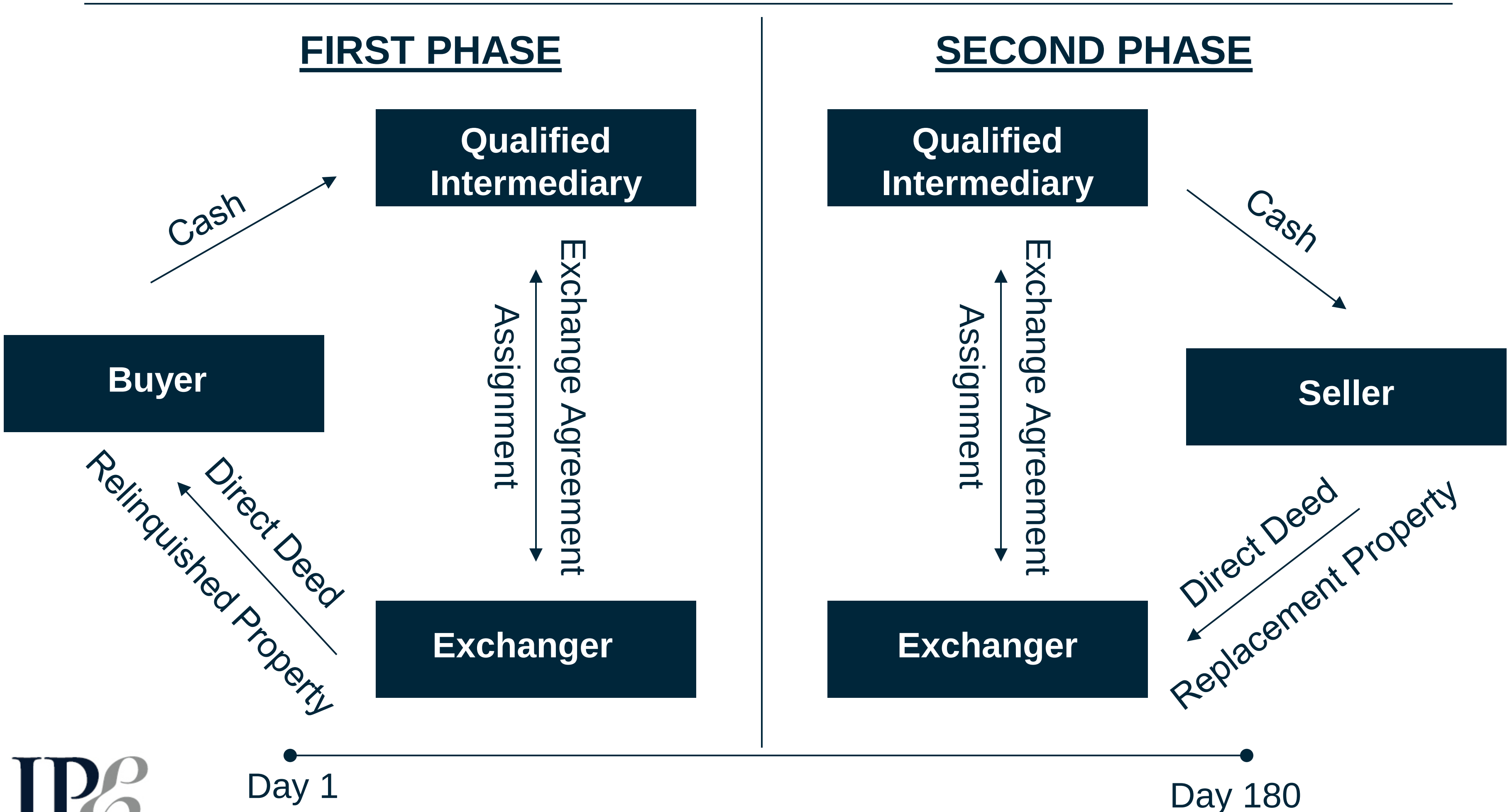
Important Rules

- **Qualified Intermediary:** Must designate Qualified Intermediary QI prior to close of relinquished property. One <u>cannot</u> simply hold funds in escrow after closing and then execute documentation.

- **45-Day Rule:** By the 45^{th} day from closing on the relinquished property, the exchanger must identify in writing, to an independent third party to the exchange transaction (Q.I.), what property(ies) he/she intends to acquire.

- **180-Day Rule:** By the 180^{th} day from closing on the relinquished property, the exchanger must acquire (close on) their replacement property(ies).

Delayed Exchange With Qualified Intermediary



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Identification Rules

1. “3-Property” Rule: An exchanger may identify up to three replacement properties without regard to their fair market value.

2. “200 Percent” Rule: An exchanger may identify any number of replacement properties, so long as their aggregate fair market value of all identified properties does not exceed 200% of the fair market value of the relinquished property on the date it was sold.

3. “95 Percent” Rule: An exchanger may identify any number of properties, without regard to fair market value, so long as 95% of the identified properties are actually acquired.

1031 Exchange for Personal Property Eliminated
Real Property vs. Personal Property

Personal property exchanges were eliminated ($30B revenue raiser).

- **However**, 1031 for personal property was replaced by allowing gain to be offset by expensing **(2025 – 40%, 2026 – 20%, 2027 – 0%)**.

- State law property classifications generally serve as guidance for what is real property, but are not determinative. Federal law ultimately controls.

- Cost segregation may recharacterize fixtures from real property to Section 1245 property for depreciation purposes only (wall coverings, lighting, special wiring). Still considered real property for 1031 purposes.

- Special categories of Section 1245 real property (single purpose ag buildings, grain bins, fence, tile) can be depreciated as personal property for federal tax purposes. Still considered real property for 1031 purposes.

Purchase / Sale Negotiations

Real versus personal property:

- The parties are bound by allocations in the purchase agreement (and the declaration of value).
- Best approach is to avoid a designation to the extent it is incidental to the larger asset.
- In 1031, QI only receives proceeds from the real property. Personal property proceeds go to exchanger at closing.

Traps

- Full expensing is no longer 100%:
  - 40% in 2025
  - 20% in 2026

  (Absent extender or reauthorization of Section 1031 for personal property.)

  Example: Sale of $400,000 combine would require a $1,000,000 purchase to fully offset gain with new depreciation at 40%.

- Be careful of sales occurring at year end: Sale of a $400,000 combine December 31, 2025 and a purchase of a new $1,000,000 combine January 1, 2026, results in 2025 recapture tax with no corresponding expense. (Plus 2026 purchase can only be depreciated at 20%.)

- This is for federal law only. State deprecation recapture tax will likely apply without setting up an exchange.

Examples: Offsetting Gain with Personal Property Expensing

Personal property purchases can be a powerful tool to offset gain from the sale of both real property and personal property assets.

Examples:

- Sale of 80 acre farm with $400,000 of gain can be offset by the purchase of $1,000,000 worth of equipment.

- Sale of 80 acre farm with $800,000 of gain can be offset by $2M hog building, grain bins and/or tiling (single purpose agricultural/horticultural structures).

- Sale of equipment (tractors, combine, tillage equipment, etc.) with depreciation recapture can be offset by purchase of other equipment or other single purpose agricultural/horticultural structures.

- Improvement exchange can be avoided to the extent land can be purchased and improvements can be expensed.

Red Flag: Not using Reverse and Improvement Exchanges

Exchangers may be confronted with situations where they cannot sell relinquished property(ies) before they buy replacement property(ies):

- Exceptional purchasing opportunities
- Relinquished property cannot be sold before replacement property closing
- Improvements are to be built on replacement property
- Planned events: Increased time flexibility

Reverse Exchange Safe Harbor – Rev. Proc. 2000-37

- Allows exchanger to park replacement property with an Exchange Accommodation Titleholder (EAT) for up to 180 days pending the disposition of the relinquished property.

- Also allows the EAT to construct improvements on the replacement property during the 180 day period.

- Rev. Proc. 2004-51: Modified Rev. Proc. 2000-37 to prevent the use of the safe harbor to exchange into new construction on land one already owns.

Reverse Exchange: Replacement Property Parked

The I.R.S. requires the EAT to hold actual title to the replacement property for reverse exchanges until the exchanger can sell the relinquished property.

Seller

Cash

Replacement Property

Exchanger

Exchange Accommodation Titleholder (EAT)

Qualified Exchange Accommodation Agreement (QEAA)

Steps to Parking Property with EAT

EAT Requirements:

- Must have qualified indicia of ownership: Hold title
- Must be subject to federal income tax
- Cannot be a disqualified person: attorney, accountant, financial advisor, realtor, certain family members
- Watch out for related party rules

Procedures:

- Set up a single-member L.L.C. wholly owned by IPE (“IPE1031 REV150, LLC” or another name so the LLC can be sold to exchanger.)
- Environmental liability

Steps to Parking Property with EAT

Procedures Continued:

- Arrange financing: Non-recourse from bank or exchanger to EAT, mortgage from EAT.
- Assignment of Purchase Agreement from exchanger to EAT / Notice of Assignment to Seller
- Real Estate Acquisition and Qualified Exchange Accommodation Agreement (QEAA) – Must be within five business days after the transfer to EAT.
  - Includes Lease to exchanger
  - Includes relinquished property identification form (45 days to identify <u>relinquished</u> property, 180 days to complete reverse exchange)
  - $1,000,000 general insurance liability policy with EAT as additional insured

Steps to Parking Property with EAT

Procedures Continued:

- Closing instructions to closer (Seller to EAT):
    - Property deeded to EAT
    - Title opinion/commitment to EAT
    - Notice of Assignment signed by seller
    - Request review of settlement statement
- Identification Period:
    - 45 days to change or add relinquished properties to be sold
    - 180 days to sell relinquished properties and transfer replacement property from EAT to exchanger
- Relinquished property sale to buyer
    - Relinquished property proceeds to QI

Steps to Transfer Parked Property to Exchanger

- Closing instructions to closer (EAT to Seller):
- Property deeded from EAT to Exchanger (or transfer LLC shares to Exchanger as a disregarded entity)
- Assignment of Real Estate Acquisition and Qualified Exchange Accommodation Agreement to QI
- Notice of Assignment signed by EAT
- Request review of settlement statement: Exchange proceeds are used to pay down note to bank or exchanger
- Dissolve LLC
- File tax return for LLC to report acquisition and sale of parked property

Qualifying Like-Kind Properties

Real property used in a trade or business or held for investment

NOT

Improvements that are not constructed at the time of the purchase (Improvements must be complete to be considered real estate)

Constructing Improvements

- Must be done before property is acquired by Exchanger.
- Can be constructed by the seller, prior to transfer of title of the property to Exchanger.
- Can be constructed by a developer or contractor who holds title to the property.
- <u>Cannot</u> be constructed by the exchanger after property is acquired.
- Can be done by an Exchange Accommodation Titleholder (EAT) in an improvement exchange

Constructing Improvements with an EAT

- Can be done as either a forward or a reverse exchange
- Improvements need not be complete by day 180. Anything that is complete qualifies
- Construction management permitted
- Exchanger may finance improvements
- EAT pays contractors directly and accounts for payments

Related Party Leasehold Improvement Exchanges

Problem: What if exchanger wants to exchange into improvements on land owned by a related party?

- We know we can't buy replacement property from a related party

Solution: Leasehold improvement exchange

- Related party retains ownership in the underlying ground
- FMV lease rate is paid for a term of more than 30 years
- Improvements are transferred to exchanger subject to ground lease
- Two years later – collapse the lease into the improved property

Reverse Exchange Avoidance (Tip)

- Extend closing date:
  - Offer additional earnest money
  - Option agreement
  - Rental agreement
  - Lease/option agreement

- Use caution: The more it appears the "benefits and burdens of ownership" have been transferred, the more likely exchange will be disallowed.

1031 Examples in the Land Context

- Combine acres / exchange into higher quality ground
- Keeping the farm in the family – the beginning farmer
- Keeping the farm in the family – sibling acquisitions, stepped-up basis
- Retirement planning
- Diversification of asset type
- Relocation of operation
- Improve livestock operation
- Promote conservation

Top Ten Exchange Red Flags

1. Qualified intermediary requirements
2. Not asking the right questions
3. Unassignable purchase agreements
4. Trading down in value
5. Reverse exchange avoidance

Top Ten Exchange Red Flags

6. Not documenting the exchange correctly
7. Related party transactions
8. Flippers and dealers
9. Settlement statement problems
10. Partnership issues

Role of a Qualified Intermediary

- The I.R.S. requires that exchangers use the services of a qualified intermediary (Q.I.) to accommodate a Section 1031 delayed exchange and hold sale proceeds in trust.

- **MISTAKE: Persons who cannot serve as a Q.I.:**

  Any agent of the taxpayer – attorney, accountant, real estate agent/broker, investment advisor/broker, or employee within two years prior to sale of relinquished property.

  Family members and other persons or entities related to the exchanger. **(Attribution rules)**

What a Q.I. Does

- Check for Red Flags: What are the potential problems that would disqualify a transaction or necessitate an alternative structure?

- Assist the Exchanger: Planning, planning, planning

- Assist Exchanger's Advisors

- Serving as a resource to real estate, tax, and legal professionals so that you can help your clients.

Q.I. Role Continued

- Prepares Documents:
  - Cooperation Addendum
  - Exchange Agreement
  - Assignments and Notices
  - Closing Instructions
  - Identification Notices and Documents
  - Exchange Account Documents
- Monitor Time Deadlines
- Ensure Technical Compliance with 1031
- Invest and manage funds (Bonded and E&O Insured)

Choosing your Qualified Intermediary

- Qualifications
- Fidelity bond coverage
- Error and omissions insurance
- Dual signature requirements
- Segregated exchange accounts
- Custodial exchange accounts
- Independent accounting review of company records

Red Flag: Not Asking the Right Questions

- Type of Property Being Relinquished
- Length of Ownership
- FMV / Basis / Gain of Relinquished
- Debt on the Property
- How Title is Held / Nature of Entity Business
- Replacement Property Type
- Value of Replacement Property
- Improvements
- Related Party Replacement Property Seller
- How Title to be Held for Replacement
- Vacation Homes
- Personal Residences

Red Flag: Purchase Agreement Defects

- Assignable
- Foreclosures specifically
- Exchange Cooperation language
- All Exchangers Parties to the Contract
- Closing Dates in Sequence (Reverse Exchange?)
- 1031 Disclosure in Replacement Property Agreement

Red Flag: Prohibited Related Party Transactions

- Basic Rule: Related parties can exchange property if both parties hold replacement properties for two years.

- **MISTAKE:** Common Misconception - An exchanger can acquire replacement property from a related party in a deferred exchange if they sold relinquished property to an unrelated party as long as held for two years.

- I.R.S. prohibits basis shifting.

Related Parties Defined

- Family Members: siblings, spouse, ancestors, lineal descendents. NOT: Aunt, uncle, in-laws, cousins.

- Individual and corporation where 50% is owned directly or indirectly by such individual.

- Two corporations part of the same control group.

- Others as described in Section 267(b) or 707(b) of I.R.C.

Related Parties (Basis Shift Example)

Brother's Property

Brother sells to Exchanger:

$400,000	Sale Price
- $300,000	Basis
$100,000	Gain
x 25%	Tax Rate
$ 25,000	Tax Paid

Exchanger's Property

Exchanger sells to investor:

$400,000	Sale Price
- $100,000	Basis
$300,000	Gain
x 25%	Tax Rate
$ 75,000	Tax deferred with 1031

Investor's Purchase

Investor (unrelated) purchased property from Exchanger for $400,000

Revenue Ruling 2002-83 specifically prohibits because Brother pays less tax than what Exchanger would have paid if he sold outright without executing a 1031 exchange. This transaction, or series of transactions, is structured to avoid tax.

Related Parties (Example: No Basis Shift)

Brother's Property

Brother sells to Exchanger:

$400,000	Sale Price
- $100,000	Basis
$300,000	Gain
x 25%	Tax Rate
$ 75,000	Tax Paid

→

Exchanger's Property

Exchanger sells to Investor:

$400,000	Sale Price
- $300,000	Basis
$100,000	Gain
x 25%	Tax Rate
$ 25,000	Tax deferred with 1031

→

Investor's Purchase

Investor (unrelated) purchased property from Exchanger for $400,000

This is a related party transaction that is not prohibited by Revenue Ruling 2002-83 because Brother pays more tax than Exchanger would have. No primary motive to avoid federal income tax. PLR 200730002

Related Parties (Example: No Cash Out)

Seller's Property

Seller (unrelated) sells property to Brother for $400,000

Brother's Property

Brother sells to Exchanger:

$400,000	Sale Price
- $300,000	Basis
$100,000	Gain
x 25%	Tax Rate
$ 25,000	Tax deferred with 1031

Exchanger's Property

Exchanger buys from Brother:

$400,000	Sale Price
- $100,000	Basis
$300,000	Gain
x 25%	Tax Rate
$ 75,000	Tax deferred with 1031

Buyer's Property

Buyer (unrelated) buys property from Exchanger for $400,000

PLR 200440002 / PLR200807005: Both Exchanger and Brother are executing a 1031 exchange. Neither are cashing out of their investment, thus there is no tax avoidance motive. The transaction is permissible. Both Exchanger and Brother must hold the property for two years.

Red Flag: Properties Held for Resale, Dealers, Flippers and Non-qualifying Uses

- Dealer properties do not qualify for Section 1031 treatment.
  - Developers and contractors
  - Condominium conversions
  - “Fixer-uppers” and “flippers”

Avoiding Dealer Status

Facts:

- Broker is in the business of selling real estate, developing land, renting properties, construction and flipping undervalued acquisition opportunities.

Issue:

- Broker’s “dealer” activities can cause all assets to be considered “inventory,” thus being taxed at ordinary income tax rates.

Avoiding Dealer Status

Solutions:

- Segregate activities: Different entities, separate books and distinct governance. Not just disregarded LLCs.

- Sell appreciated assets to be developed to a related party dealer entity.

Red Flag: Settlement Statement Problems

- Permitted Exchange Expenses
- Debt Payoffs Related to Relinquished Property
- Rents and Deposits
- All Exchange Equity Applied to Replacement Purchase
- Over Financing on Replacement

Red Flag: Partnership Issues

- The same taxpayer who sells property in an exchange must acquire the replacement property.
- LLCs – Multi-member LLCs are considered partnerships for federal tax purposes
- Partners of multi-member LLCs cannot exchange into separate properties
- Solution: Drop and Swap / Swap and Drop

Partnerships Continued (Drop and Swap)

Convert the partnership to a tenancy-in-common (TIC)

1. Execute and record a deed to transfer all partnership real property to the former partners.
2. Terminate the partnership and any partnership agreement.
3. Assign all leases to the former partners as TIC. Payments to partners.
4. Transfer all assets of partnership to former partners. Notify all creditors of change, close bank accounts.
5. Pay taxes and obligations as individual partners.

Partnerships Continued (Drop and Swap)

Convert the partnership to a tenancy-in-common

6. Purchase and sale agreement in names of formers partners and not in the name of the partnership.
7. Timely file a final partnership tax return.
8. File a protective election under Section 761(a), which allows a partnership to elect out of partnership status.
9. Execute a tenancy-in-common agreement.

Partnerships Continued (Swap and Drop)

- Partnership executes the exchange.
- Replacement properties are contributed to partners individually.
- Partnership is terminated as previously stated.

Checklist For Real Estate Professionals

__ Determine if client's property is used for investment or used in a trade or business (personal residence does not qualify)

__ Notify client that their property may be a good candidate for 1031 treatment

__ Suggest that they contact a Q.I., accountant, and/or lawyer with 1031 experience

Checklist Continued

__ Mention 45-day and 180-day deadlines

__ Make sure closing does not occur without hiring a Q.I. and signing exchange documents

__ Include cooperation language in Purchase and Sale Agreement

"It is the intention of seller to transfer the above-listed property pursuant to I.R.C. Section 1031, which sets forth the requirements for tax-deferred real estate exchanges. Seller's rights and obligations under this and future agreements will be assigned to a qualified intermediary for the purpose of completing the exchange. Buyer agrees to cooperate with seller and qualified intermediary in a manner necessary to enable seller to complete the exchange."

Red Flag Concerns

- Is the client selling to or buying from a related party?
- Does the client own their property with other persons? (Partnership concerns)
- Is the client going to close escrow before hiring a Q.I. and executing proper 1031 documents?
- Is the client going to buy property before giving up their relinquished property? (Reverse exchange)
- Does your client want to build improvements on their replacement property using exchange funds?
- Is the client a dealer?

Use Us As Your Resource

Please do not hesitate to call us if you have questions about a transaction or Section 1031 generally.

QUALIFIED INTERMEDIARY SERVICES

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