



Advanced Issues in Tax Deferred Exchanges under IRC §1031

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for the

Lake County Property Investors
Association

August 2008



Internal Revenue Code Section 1031

“No gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like-kind which is to be held either for productive use in a trade or business or for investment.”

§1031 **DEFERS** taxes . . . **NOT** a tax-free transaction.

Investors complete tax-deferred exchanges to defer the capital gain tax on the disposition of their investment properties. The motivation to exchange often falls along standard risk-reward or cash flow-appreciation scales. If a **seller of investment property plans to purchase and reinvest the funds in another investment property and has a capital gains tax consequence, the purchase contract should include exchange cooperation language.**

WHEN IS AN EXCHANGE APPROPRIATE?

Before entering into an exchange the Exchanger must consider the following:

1. Does the Exchanger really want replacement like kind property?
2. Will the tax benefit from using an exchange outweigh the transaction costs?

Comparing the Tax Consequence: A Sale Versus the Exchange of Investment Property

To Estimate the Potential Capital Gain Tax:

1. Calculate the adjusted basis in the property:

Original purchase price of the property	<u>\$200,000</u>
<i>Plus non-expensed</i> capital improvements	<u>\$ 35,000</u>
<i>Minus</i> depreciation on improvements (27.5 yr. for 3 years for residential rental)	<u>\$ 25,636 (1)</u>
Equals Adjusted Basis	<u>\$209,364 (2)</u>

(1) $(\$200,000 + \$35,000) / 27.5 \times 3 \text{ YEARS} = \$25,636$ (2) $\$235,000 - \$25,636 = \$209,364$

Comparing the Tax Consequence: A Sale Versus the Exchange of Investment Property (cont'd)

2. Use the adjusted basis to determine the total gain on the sale:

Sales price of property	\$450,000
<i>Minus</i> transactions costs	\$ 31,500
<i>Minus</i> adjusted basis	\$209,364
Equals Total Gain on Sale	\$209,136

(Always consult with your own tax/legal advisor.)

This is the amount of tax that is deferred with a 1031 Exchange!

(Always consult with your own tax/legal advisor)

Deferred Exchange Benefit Summary

Federal Tax on Long Term Capital Gain	<u>\$27,525 (A)</u>
<i>Plus</i> Federal Tax on Depreciation Recapture	<u>\$6,409 (B)</u>
<i>Plus</i> State Capital Gain Tax	<u>\$14,640 (C)</u>
Equals Total Combined Capital Gain Tax	<u>\$48,574</u>

(A) (Total Gain – Depreciation) x Fed Tax Rate on L/T Capital Gain Rate

$$(209,136 - 25,636) = 183,500 \times 15\% = 27,525$$

(B) Capital Gain from Depreciation Recapture x Fed Tax Rate on Depreciation Recapture

$$25,636 \times 25\% = 6,409$$

(C) Total Gain on Sale x State Capital Gain Tax Rate

$$209,136 \times 7\% = 14,640$$

Like Kind Property

1. “Like kind” refers to the nature or character of the property and not its grade or quality.
2. Generally, all real property is “like kind” to all other real property
3. Real property can be improved or unimproved because this only relates to the grade or quality, not its kind or class.
4. The Exchanger’s intent must be to hold the replacement property as an investment, or for productive use in a trade or business.

Like Kind Property (cont'd)

With the proper intent, the following are examples of like-kind property exchanges:

- Residential for commercial
- Commercial for industrial
- Single family for multi-family
- Non-income, vacant land for income producing

Like Kind Property - Personal

1. North American Industry Classification System (NAICS)
2. General Asset Classes (SIC Codes)
3. Other Asset Classes
 - a. Intellectual/Intangible Property
 - b. Works of Art
 - c. Collectibles
 - d. Livestock

Exclusions to Section 1031

IRC Section 1031 does not apply to any exchange of:

- Stocks, bonds or notes
- Securities or evidences of indebtedness or interest
- Certificates of trust or beneficial interests
- Interests in partnerships
- Choses in action

Qualified Purpose Test

“Held for use in Trade or Business or Investment”

1. Not Held for Sale

- Inventory
- Other instances of “Held for Sale”

2. Not Held for Personal Use

- Residences (IRC §121)
- Vacation Homes
 - Tax Court Memo 2007-134 (Moore Case)
Taxpayer’s mere expectation of appreciation of the property is not enough.
 - Safe Harbor: Rev. Proc. 2008-16
How to qualify a vacation home for a 1031 exchange

3. Test is at time of Exchange

4. No required minimum holding period

QUALIFYING USE

“Held For” Test

- Only “property held for productive use in a trade or business or for investment” may be exchanged.
- Areas of concern:
 - Inventory
 - Developer
 - Subdividing / Rezoning / Street & Utilities
 - Orderly Liquidation (Ganghi v. Tax Commissioner)

QUALIFYING USE

“Held For” Test

Stock in Trade or Dealer Property

Property included in dealer inventory

Held for Sale in the ordinary course of taxpayer’s trade or business

Factors:

Extent of Improvements

Frequency of Sales

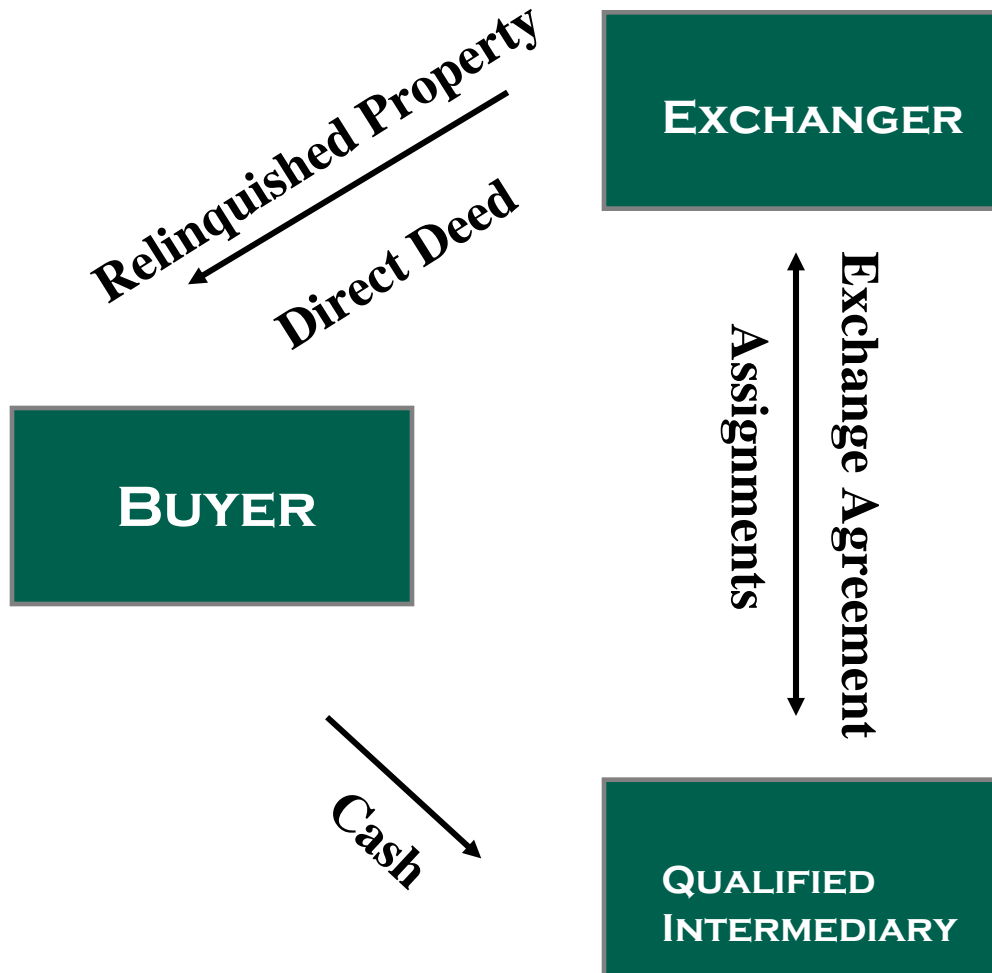
Purpose/Intent

Actual use

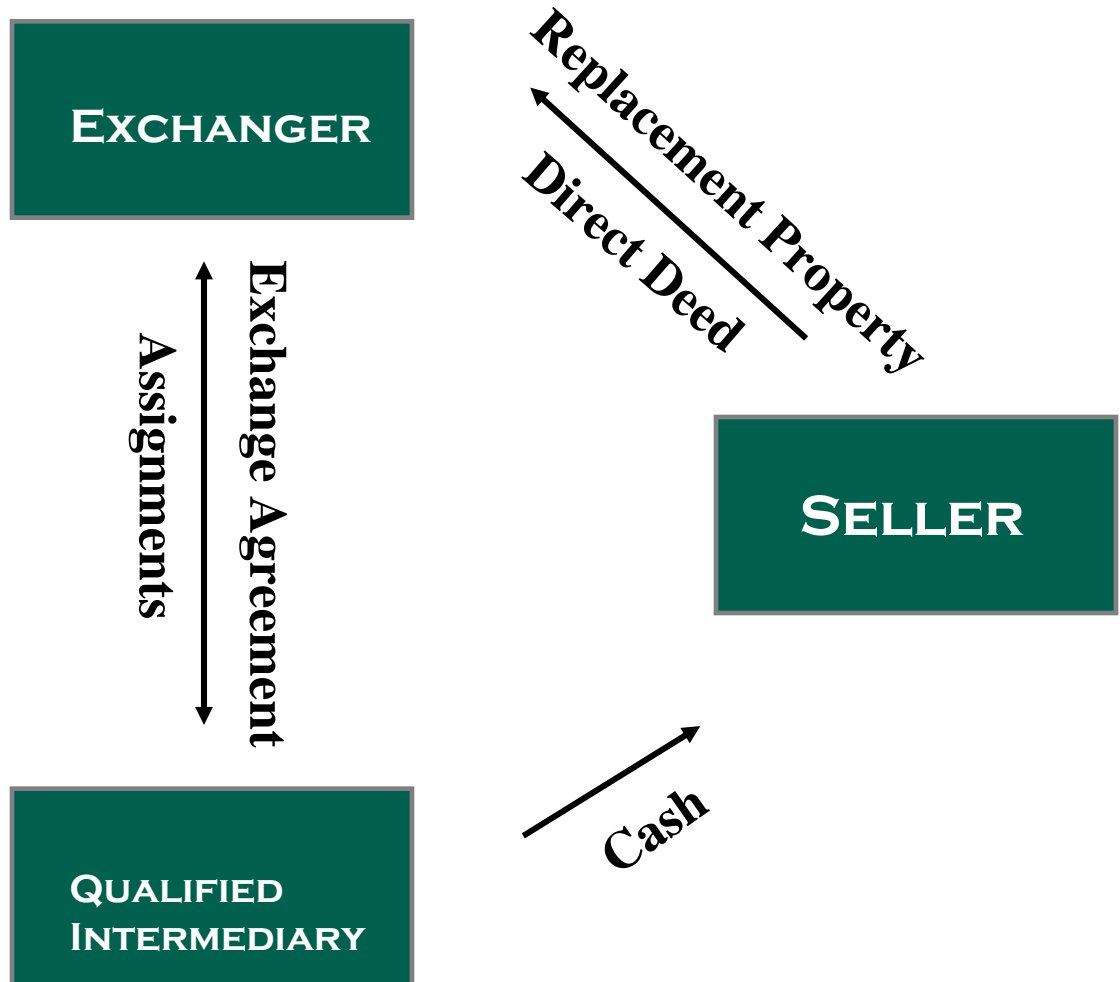
Ordinary business

Advertising/Promotion

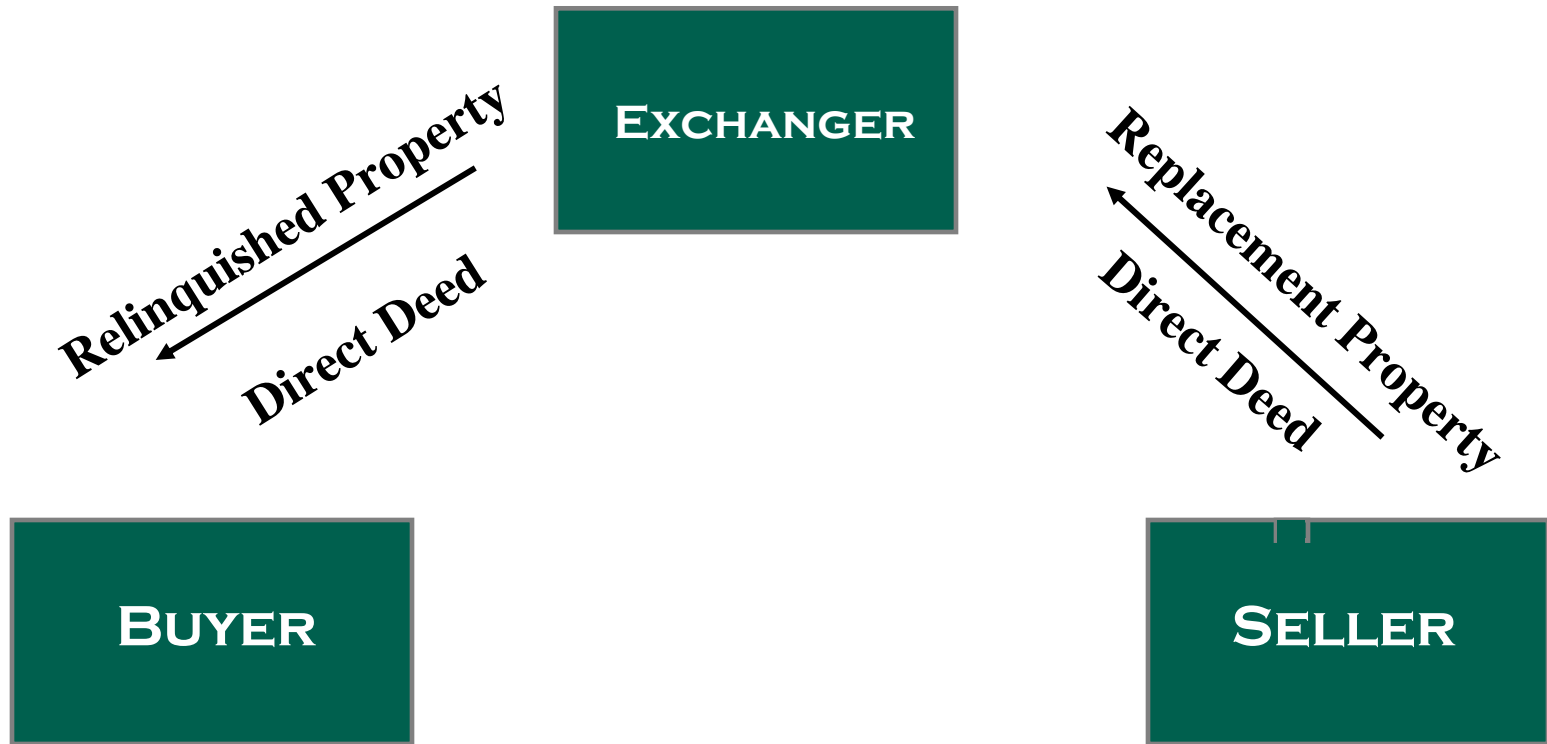
Delayed Exchange Phase One



Delayed Exchange Phase Two



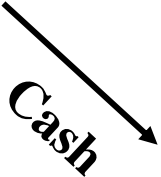
Delayed Exchange - Exchanger



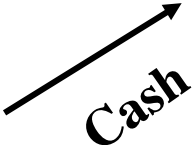
Delayed Exchange – Qualified Intermediary

BUYER

SELLER

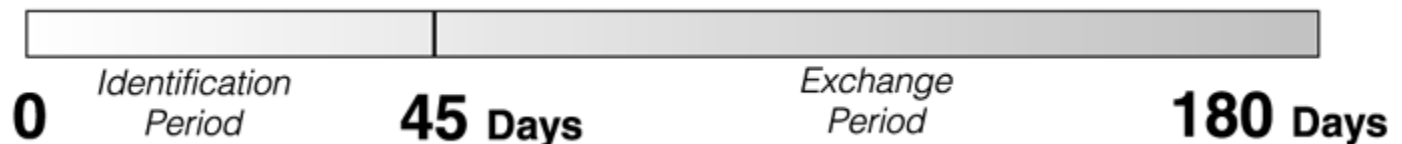


**QUALIFIED
INTERMEDIARY**



Delayed Exchange Time Limits

1. **180-Day Rule**: The Exchanger must acquire all the replacement property (ies) within 180 days, or the date the Exchanger must file the tax return (including extensions) for the year of the transfer of the relinquished property, whichever occurs first.
2. **45-Day Rule**: The Exchanger must identify the potential replacement property (ies) within the first 45 days of the 180-day Exchange Period.
3. There is no extension for these deadlines for Saturdays, Sundays or holidays.
4. The time limits begin to run on the date the Exchanger transfers the first relinquished property to the buyer.
5. The “date of transfer” will be the date of recording or transfer of the benefits and burdens of ownership, whichever occurs first.



Basic 1031 Rules

As a general “rule of thumb,” to obtain a deferral of the entire capital gain tax the Exchanger must:

1. Reinvest all of the net proceeds from the relinquished property.
2. Obtain equal or greater financing on the replacement property than was paid off on the relinquished property (Replacement property debt can be offset with cash put into the exchange.).
3. Receive nothing in the exchange but *like kind* property.

To the extent the Exchanger fails to observe these rules, they will be subject to capital gain taxes.

Thumb-nail test for 100% deferral: => in value; => equity.

QUALIFYING USE

One Property: Two Qualifying Uses

Combining 121 and 1031 (Rev. Proc. 2005-14)

- Qualifying criteria: Home Office / Duplex / Conversion to rental
 - RLQ must have §1031 qualifying use at the time of sale
 - RLQ must have been used as taxpayer's primary residence
- Guiding principles:
 - 1st apply only I.R.C. §121; then apply I.R.C §1031
 - Only I.R.C §1031 applies to depreciation recapture
 - Boot is only recognized to the extent it exceeds the gain excluded under I.R.C. §121
 - Gain excluded under I.R.C. §121 is added to basis of the I.R.C §1031 RPL acquired

Exchange Vesting Issues

With few exceptions in an exchange, title to the Replacement Property must be held in the same manner as title was held on the Relinquished Property

1. Examples:

- Husband Relinquishes → Husband Acquires
- Partnership ABE Relinquishes → Partnership ABE Acquires
- ACME, Inc. Relinquishes → ACME, Inc. Acquires

Exchange Vesting Issues (Cont'd)

Acceptable Variations:

1. Grantor Trust (e.g. revocable living trust): Trustee takes title to replacement property as an individual and then transfers it later to trust. Trust is disregarded for tax purposes.
2. Death of Exchanger: If Exchanger dies, Exchanger's estate can complete exchange.
3. Single Asset Entities: Exchanger who relinquished as an individual can acquire replacement property in a single-owner LLC. This entity is disregarded for tax purposes under the "check the box" rules.

Areas of Concern:

1. Lender may not loan to a trust and requires individual as borrower.
2. Lender qualification requires wife to be on loan and deed with husband, but husband is the only Exchanger.

Partnership Issues in an Exchange

Scenario 1: All partners want to exchange but not replace into the same property (*no contract for sale in place yet*) – **DROP & SWAP**

- Dissolve partnership / Distribute partnership / property pro-rata as co-tenants
- Each co-tenant exchanges co-tenancy interest for separate property under 1031

Issues: IRC §704(c)(1)(B) / §737 / §707(a)(2) Tenancy in Common v. Partnership Classification

Scenario 2: All partners want to exchange but not replace into the same property (*contract for sale in place*)

- **Issues:** Holding for Sale
- **Possible Solutions:** Swap & Drop / Partnership replaces and stays together / Partnership Division

Scenario 3: Not all partners want to exchange but the rest of the partners want to stay together in the partnership and exchange as a partnership.

- Possible solutions:
 - Buy out retiring/liquidating partner with cash or promissory note
 - Bring new partner to buy non-exchanging partner's interest in the partnership

Partnership Issues in an Exchange

Techniques to consider when all partners do not wish to pursue the same reinvestment strategy

1. Special allocations; substantial economic effect under 704(b)
2. Transfer of Undivided Fractional Interests
3. Purchase of multiple replacement properties, with subsequent partnership liquidation
4. Installment Note to the “cash-out” partner

Structuring a Reverse Exchange

Important Note: Until September 15, 2000, taxpayers had no guidance for Reverse Exchanges under the Internal Revenue Code.

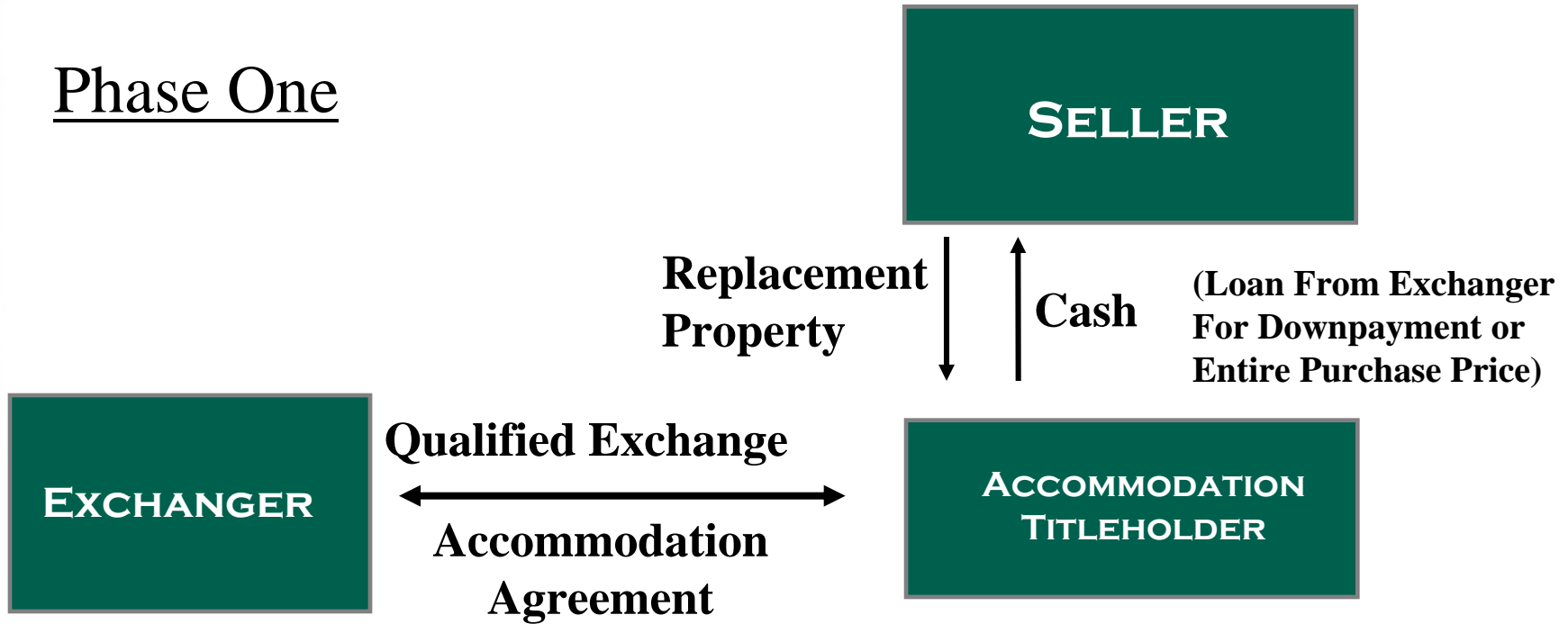
Rev. Proc. 2000-37 created “safe harbors” for some Reverse Exchanges. To the extent possible, Qualified Intermediaries attempt to follow the exchange rules set forth in the Rev. Proc. in order to fall within the safe harbor. Consider the following:

- A. The Exchanger may not hold title to both properties at the same time. To the extent there are exchange funds, the Exchanger may not control those funds in any way.**
- B. The exchange should be completed within 180 days from the transfer of the relinquished property to be within the safe harbor.**
- C. The replacement property should consume all cash from the transfer of the relinquished property.**
- D. It is possible to “park” either the Replacement Property or the Relinquished Property.**
- E. A Reverse Exchange is more expensive and complicated than a Delayed Exchange, and should be used as a last alternative.**

Reverse Exchange

Parking Title to the Replacement Property
(Restructured as a Simultaneous Exchange on Phase II)

Phase One

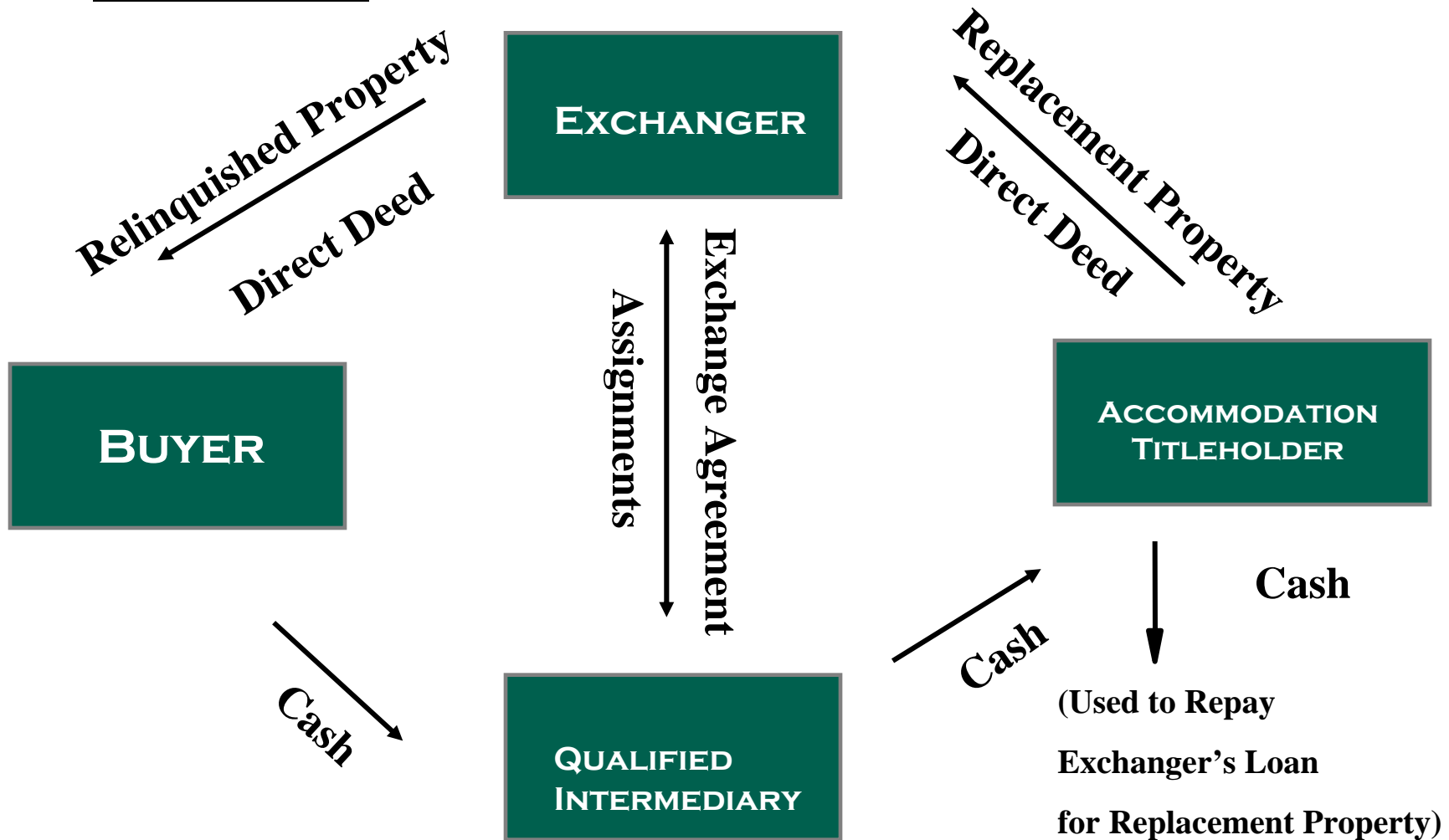


Intermediary holds title to Replacement Property until Exchanger can sell Relinquished Property.

REVERSE EXCHANGE

Parking Title to the Replacement Property

Phase Two



Reverse Exchange Deadlines

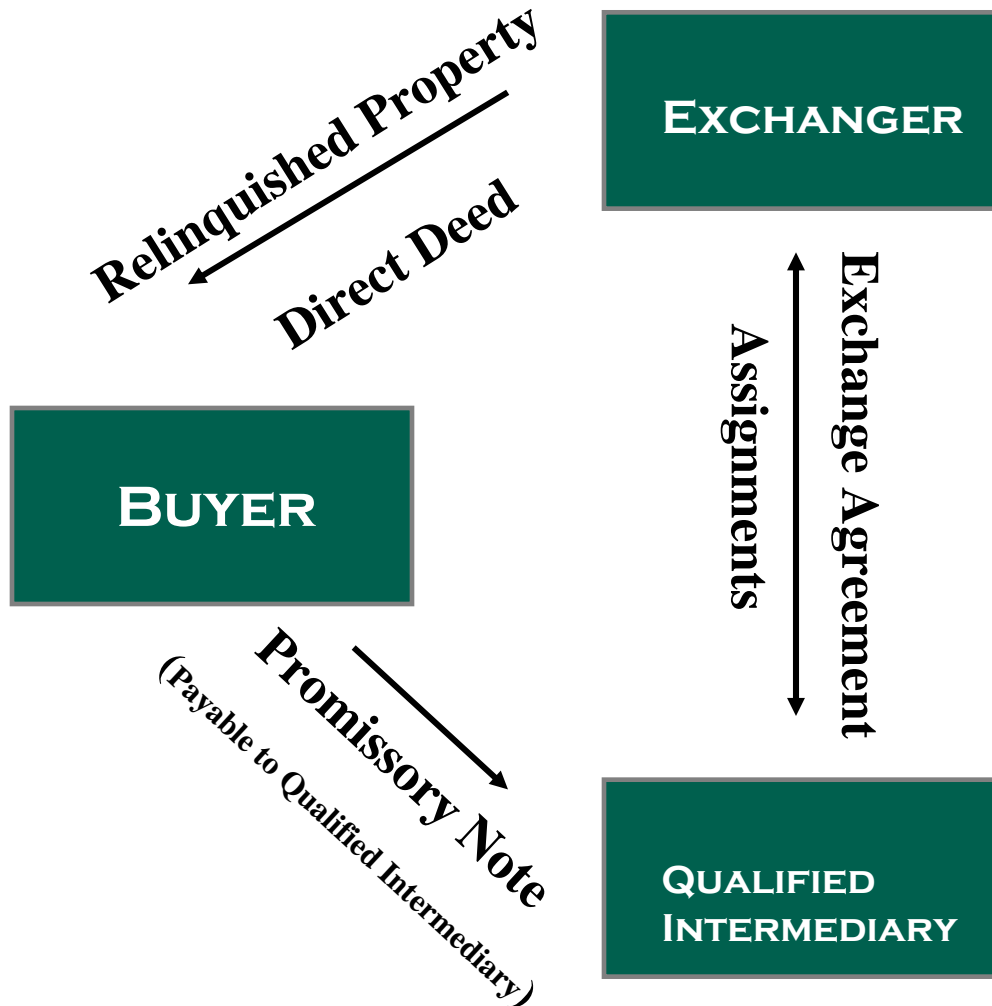
- QEAA must be executed within five business days after AT acquires “parked property”
- Alternative or multiple relinquished properties must be identified within 45 days after AT acquires “parked property”
- Exchange must be completed within 180 days for “safe harbor” compliance

Cost Segregation Issues

Cost Segregation:

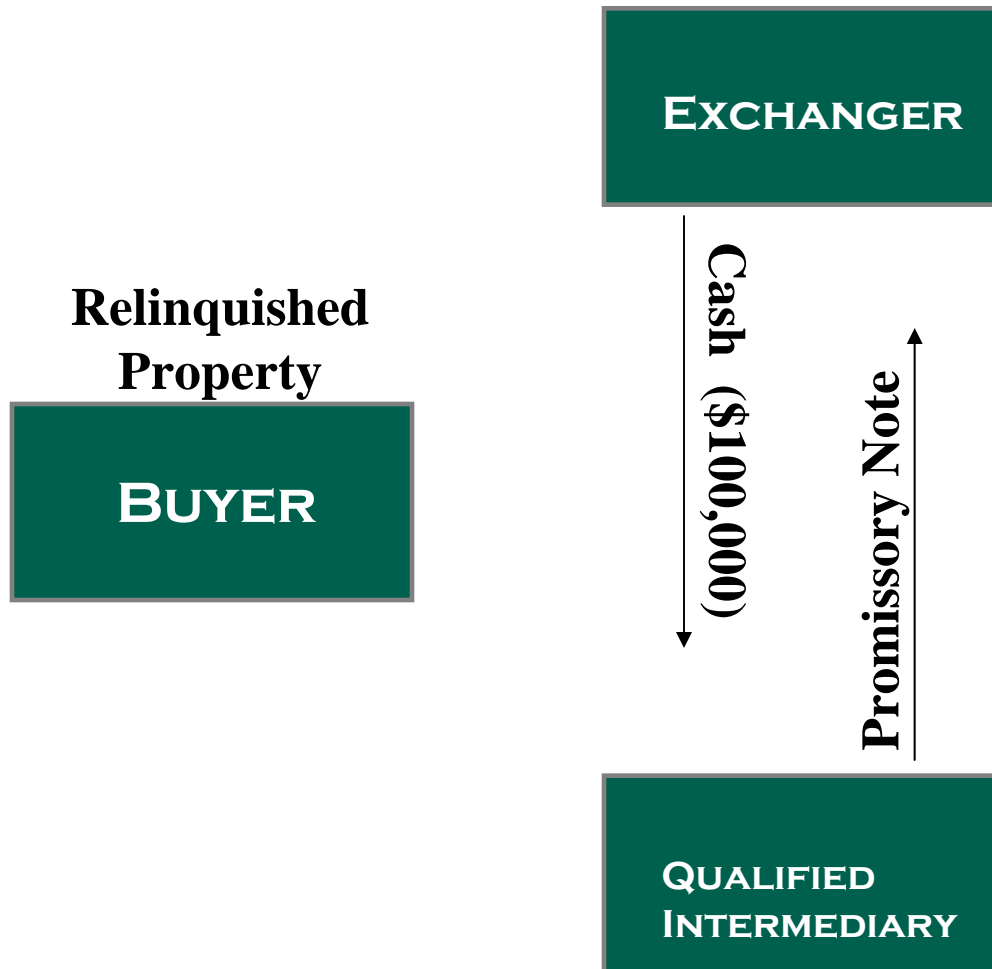
- Definition
- Problems when electing cost segregation
- ILM 200648026 Tangible Personal Property
- Personal Property v. Fixtures

Delayed Exchange – Seller Finance Phase One



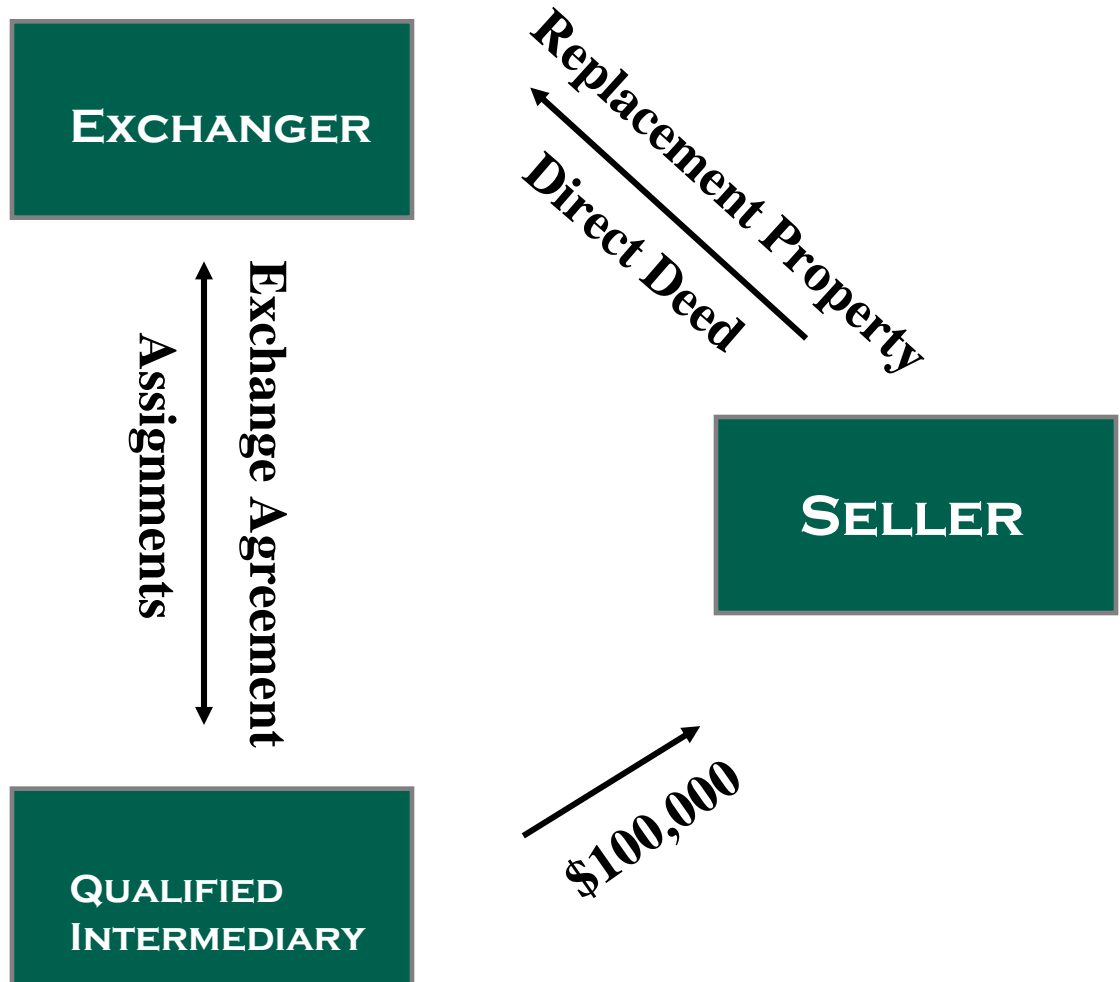
Due Date	Payment Amount	
	Principal	Interest
Month 1	10,000	130
Month 2	10,000	130
Month 3	10,000	130
Month 4	10,000	130
Month 5	10,000	130
Month 6 (or day 180)	10,000	130
	\$60,000	
Month 7	10,000	130
Month 8	10,000	130
Month 9	10,000	130
Month 10	10,000	130
Total:	\$ 100,000	\$ 1,300

Delayed Exchange – Seller Finance Phase Two



Due Date	Payment Amount	
	Principal	Interest
Month 1	10,000	130
Month 2	10,000	130
Month 3	10,000	130
Month 4	10,000	130
Month 5	10,000	130
Month 6	10,000	130
Month 7	10,000	130
Month 8	10,000	130
Month 9	10,000	130
Month 10	10,000	130
Total:	\$ 100,000	\$ 1,300

Delayed Exchange – Seller Finance Phase Three



Alternative Replacement Property Providers

1. Rev Proc 2000-46
2. Rev Proc 2002-22; PLR 200327039 addresses **Tenancy-In-Common Programs (TICs)**
3. Features of Undivided Fractional Interest Properties
 - a. Size
 - b. Non-Recourse Debt
 - c. No Management Responsibility
 - d. Attractive Rate of Return, with Some Shelter
4. Marketing channels for TICs
 - a. Broker/Dealer Network (Must comply with SEC rules)
 - b. Realty brokerage network (sold as real property)

Installment Sale

(Section 453)

In an Installment Sale a Taxpayer:

1. **Receives a note for some or all of the sale proceeds**
2. **Recognizes gain on the deferred portion of the sale only as and when payments are received**
3. **Has the risk of buyer will default on the deferred payments, even if the Note is secured by a mortgage**
 - *Seller does not want the property back*
 - *Seller wants the payment stream*

What is a §1031 Fall-Back? (*cont'd*)

4. **PRIOR TO TERMINATION OF THE EXCHANGE,** the Exchanger gives QI an **IRREVOCABLE DIRECTION** to pay the Exchange Funds to an Assignment Company and the Exchange Agreement is amended to provide for an agreed upon Payment Stream.
5. QI Transfers the Exchange Funds to the Assignment Company which uses the money to Purchase an Annuity from an affiliated Life Insurance Company
6. The Life Insurance Company Makes Future Periodic Payments directly to the Exchanger and Issues an Irrevocable Guarantee of the Performance of the Assignment Company

Opportunities to Use a Traditional Structured Sale

1. **For the Sale of Assets Ineligible for §1031:**
 - *Primary residence over §121 exclusion limits*
 - *Personal use vacation properties*
 - *Non-Real Estate Business Assets*
2. **If the Exchanger simply wants to leave the Real Estate Asset Class and not purchase another Property**
3. **In a Failed Reverse Exchange (When a Relinquished Property is not sold until after the Safe Harbor Period)**

Opportunities to Use a §1031 Fall-Back

1. **In a Deferred Exchange when the Exchanger**
 - a) Fails to find and identify Replacement Property within 45 days (Failed §1031 Exchange)
 - b) Fails to purchase Replacement Property within 180 days (Failed §1031 Exchange)
 - c) Fails to use all of the Exchange Funds to purchase Replacement Property (Boot)
2. **In a Failed Reverse Exchange** (When the Relinquished Property is not sold until after safe harbor period)
3. **If the Exchanger simply wants to leave the Real Estate Asset Class** and not purchase another Property

Caveat: This is not as beneficial as a completed Exchange

- Since the only part of the transaction that gets the Installment Sale Treatment is the CASH that is available to purchase the annuity, it will not shelter against the immediate gain recognition of Mortgage Boot.
- On highly leveraged Relinquished Properties, it is unlikely that this structure will actually provide the client any relief or benefit.
- Therefore, further involvement by client's tax advisor and insurance licensed individuals prior to completing any structure is needed as part of this offering.

**Completing a 1031 Exchange still is
more tax advantaged**

Structured Sales

Pure Structured Sale – No 1031

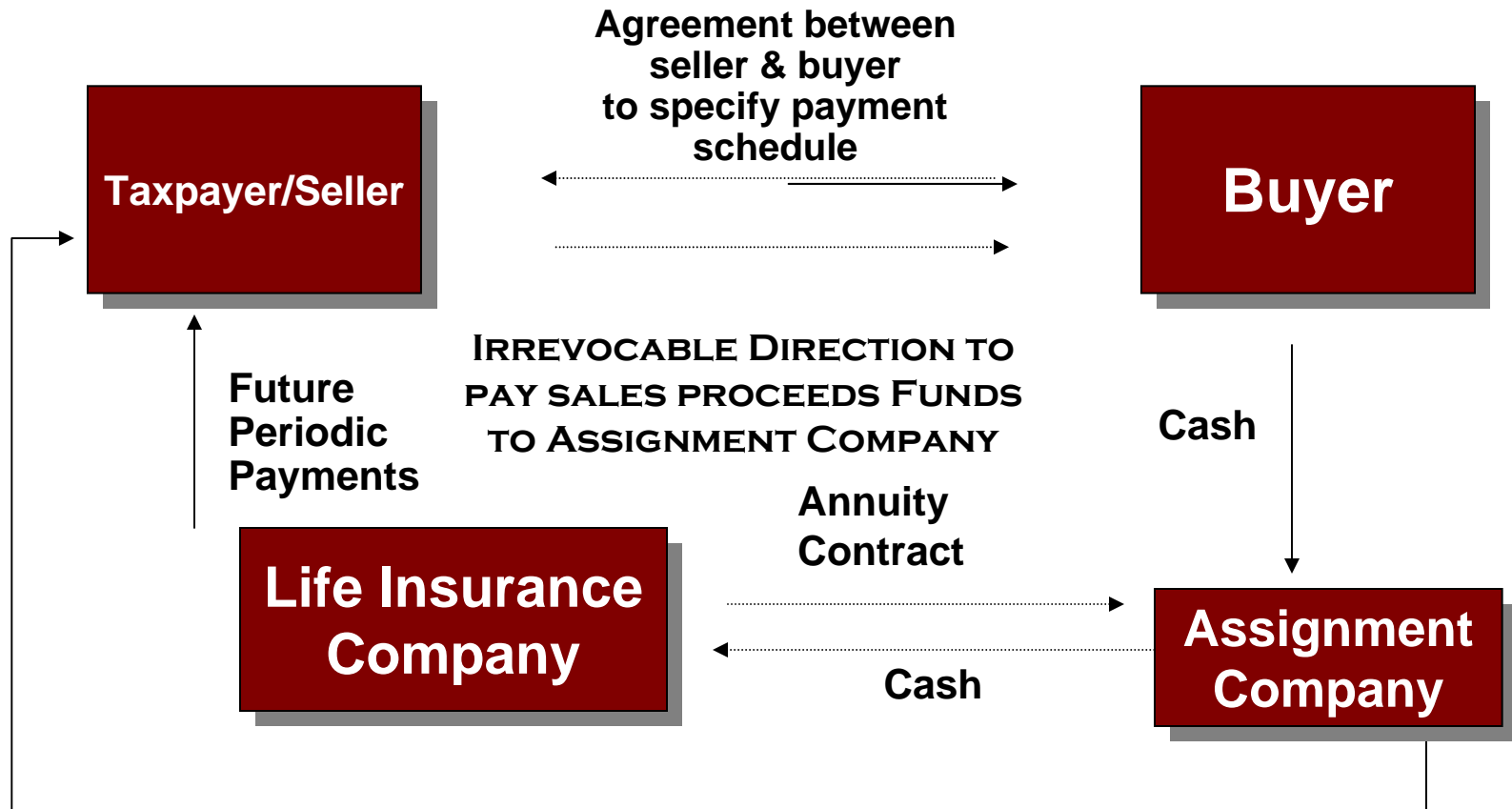
- Relinquished Property does not qualify for 1031
- Vacation homes, primary residence with excess gain over 121 exclusion
- Taxpayer does not want to reinvest in Replacement Property
- Taxpayer looking for a passive investment with no immediate need for cash

Example:

Pure Structured Sale – No 1031

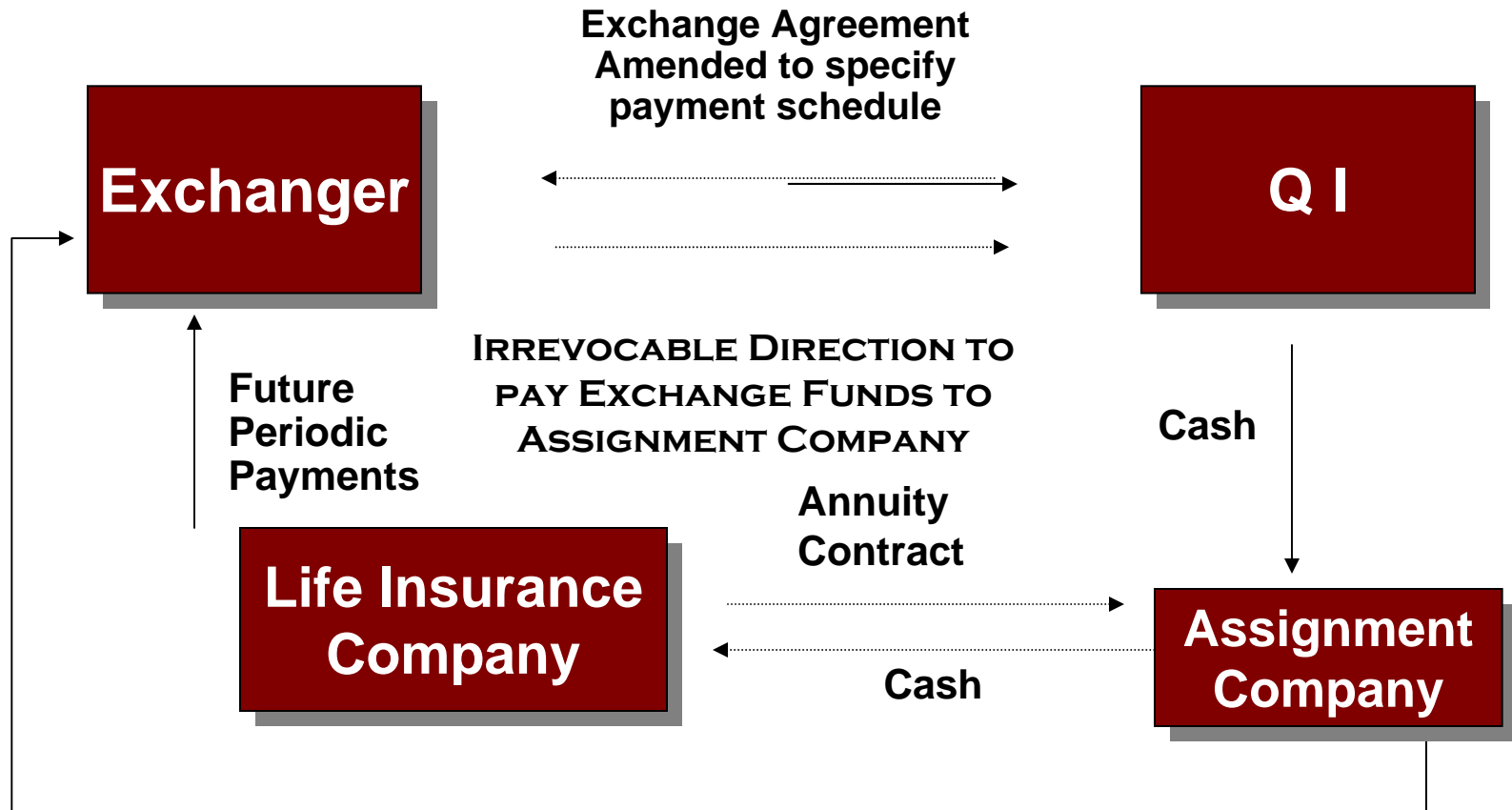
1. Client selling a personally-used vacation property that has appreciated substantially
2. Transaction not 1031 eligible, but client wants to avoid immediate gain recognition
3. **Solution:**
 - Refer to Structured Sales Company to “Structure” a 10 year payment stream with Buyer
 - Buyer assigns the Note to an Insurance Company affiliate which funds Note payments with annuity
 - Taxes are deferred and credit risk is mitigated through annuity

Structured Sale with Assignment Company and Life Insurance Company



**Financial Security for Taxpayer is
Funding of Assignment Company obligations through
Annuity issued by Allstate Life Insurance Company**

Structured Sale with Assignment Company and Life Insurance Company



Financial Security for Exchanger is
Funding of Assignment Company obligations through
Annuity issued by Life Insurance Company

Qualified Intermediary

The use of a Qualified Intermediary is essential to completing a valid delayed exchange. The Qualified Intermediary performs several vital functions in an exchange.

Acts as a Principal

To qualify as an exchange a reciprocal trade or actual exchange must take place in each IRC §1031 transaction. This means the Exchanger must enter into a written exchange agreement and assign to a Qualified Intermediary: (1) their interest as seller of the relinquished property and (2) their interest as buyer of the replacement property. By becoming an actual party to the exchange, a reciprocal trade takes place even when there are three or more parties involved in an exchange transaction (i.e. when the Exchanger is purchasing the replacement property from someone other than the buyer of their relinquished property). The Qualified Intermediary cannot be the Exchanger and must be an Independent Party (not **DISQUALIFIED**) to the transaction.

The use of a Qualified Intermediary allows for “**DIRECT DEEDING**” of the properties involved in the exchange. This is only allowed with the use of a Qualified Intermediary.

Qualified Intermediary (cont'd)

Holds Exchange Proceeds From Constructive Receipt

The Exchanger cannot have the right to receive, pledge, borrow, or otherwise receive the benefits of the exchange proceeds. If the Exchanger actually or constructively receives any of the proceeds from the sale of their relinquished property, those proceeds will be taxable as boot and the entire exchange may be jeopardized.

Prepares Legal Documentation

Several legal documents are necessary in order to properly complete an exchange, including an Exchange Agreement, two Assignment Agreements and Exchange Closing Instructions to each closer.

Provides Quality Service

Although the process is relatively simple, the rules are complicated and filled with potential pitfalls. An experienced Qualified Intermediary is essential to a smooth transaction.

Disqualified Parties

A disqualified party is a person or entity who:

1. Is a “Related Party” to the Exchanger;

OR

2. Is related to the Exchanger by substituting 10% for 50% (IRC Sections 276 (b) and 707 (b) for related corporations, partnerships or trusts);

OR

Disqualified Parties (cont'd)

3. Within the 2 years preceding the transfer of the relinquished property, the person acted as the Exchanger's:

- Employee
- Real Estate Broker or Agent
- Attorney
- Investment Bank or Broker
- Accountant

Exceptions - if the person or entity only provides the Exchanger with:

- A. Routine financial, trust, title insurance or escrow services; or
- B. Services solely with respect to the exchange of property.

Note: To obtain the Safe Harbor protection against constructive receipt of the exchange funds a disqualified person or entity may not act as an intermediary for the exchange.

Evaluating Qualified Intermediaries (QIs)

“Not all QIs are created equal”

1. Industry not regulated by the U.S. Congress
2. Security of Funds - Recent QIs Failures

What to look for when evaluating and selecting QIs:

1. Security of Funds

- a. Fidelity Bond
- b. Professional Liability Insurance
- c. Guarantee

2. Experience

- a. Number of exchanges
- b. Dedicated staff

3. Size

THANK YOU

Qs?

If you think of any questions after the conclusion of this seminar, please feel free to contact me:

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