

Section 1031 Like-Kind Exchanges: Intermediate Issues and Red Flags

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Building Strong Relationships. Creating Customized Value.

Four Options with a Property

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

Reasons to Cash Out

- Reduce debt
- Low capital gains tax rates for 2012 resulted in massive sale volume
- Diversify into different asset classes
- Start a 1031 exchange but can't find suitably priced replacement property

2020: Capital Gains Tax Rates Remain Largely Unchanged

Gain due to appreciation

- 15% up to \$200,000 (single) \$250,000 (married)
- 3.8% Net Investment Income Tax for earners over \$200,000 (single) \$250,000 (married)
- 20% for earners over \$400,000 (single) \$450,000 (married)

Gain due to depreciation (25%)

Iowa capital gains (Ordinary Income – up to 8.98% in 2018 / up to 8.53% in 2019)

Gain on properties held less than one year (Ordinary Income)

33% potential long term capital gain tax for income over \$450,000

Installment Sale – Receive Payments Over Time

GAIN CALCULATION:

\$ 1,000,000		Sale Price of Property (2020)
- 200,000		Basis of Property (1988 Purchase)
800,000		Gain

<u>Year Taxed</u>	<u>Funds</u> <u>Received</u>	<u>Basis</u>	<u>Amount</u> <u>Taxed</u>	<u>Tax</u>
2020 (15% Fed / 5% State)	\$200,000	\$40,000	\$160,000	\$32,000
2021 (20%)	\$200,000	\$40,000	\$160,000	\$32,000
2022 (20%)	\$200,000	\$40,000	\$160,000	\$32,000
2023 (20%)	\$200,000	\$40,000	\$160,000	\$32,000
2024 (20%)	\$200,000	\$40,000	\$160,000	\$32,000
Total	\$1,000,000	\$200,000	\$800,000	\$160,000

How Can 1031 Benefit Taxpayers?

- Consolidate or Diversify Investment Property Portfolio
- Derive Increased Cash Flow by Changing Investment Type
- Relocate Investment Property
- Stepped-up Basis for Heirs
- Reduce Managerial Burdens
- Eliminate Capital Gains Tax
- Interest-free Loan from Uncle Sam

Sale of \$1,000,000 Building

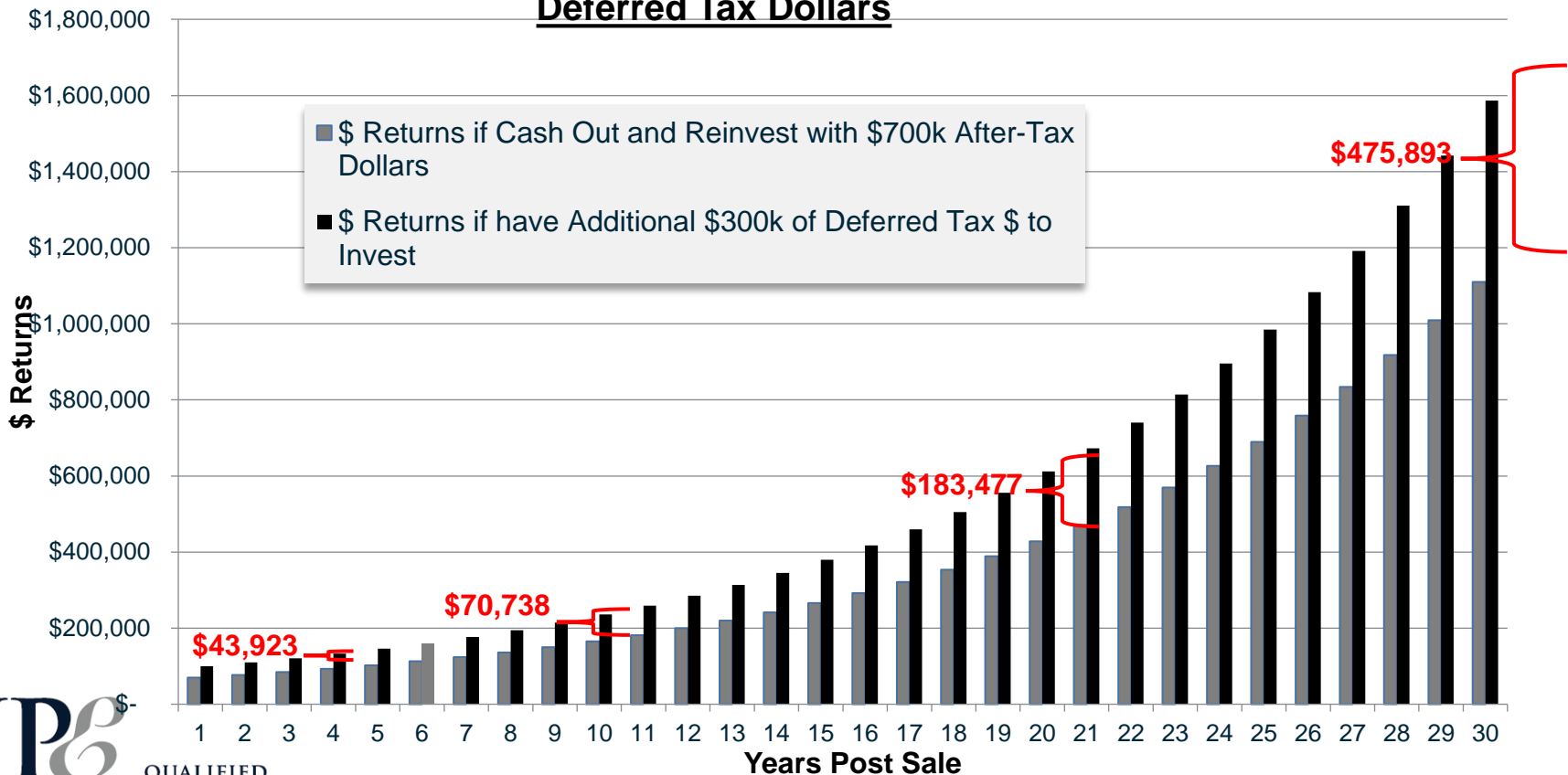
TAX CALCULATION (No Basis):

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:	\$ 90,000	(\$1,000,000 x 9%)
Total Tax Paid:	\$328,000	
Funds After Tax:	\$672,000	v. \$1,000,000

Illustration

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

\$ Returns - Reinvestment with After-Tax Dollars vs. with Add'l Deferred Tax Dollars



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 speculation)
- Golf courses and sporting complexes
- Vacation homes – under very limited circumstances
- Partial Interests – TIC %, permanent conservation easements, leases (30 years or more), contract rights, remainder interests

Real Property vs. Personal Property

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 (components of commercial real estate, single purpose ag buildings, 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

Be careful of sales occurring at year end: Sale of a hotel with \$200,000 FFE December 31, 2020 and a purchase of new \$300,000 hotel FFE January 1, 2021, results in 2020 recapture tax with no corresponding expense.

Full expensing ends in 2023 absent extender or reauthorization of Section 1031 for personal property.

This is for federal law only. State depreciation recapture tax will likely apply without setting up an exchange. Watch out for dealer trades of equipment as state tax could be due.

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 Cont.

- 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)

Designation of a Qualified Intermediary (Trap)

- Must designate QI prior to close of relinquished property
- **MISTAKE: Cannot simply hold funds in escrow after closing and then execute documentation**

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: Trading Down in Value

To defer all 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

<u>Property</u>	<u>Relinquished Property</u>	<u>Replacement</u>
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

<u>Property</u>	<u>Relinquished Property</u>	<u>Replacement</u>
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.

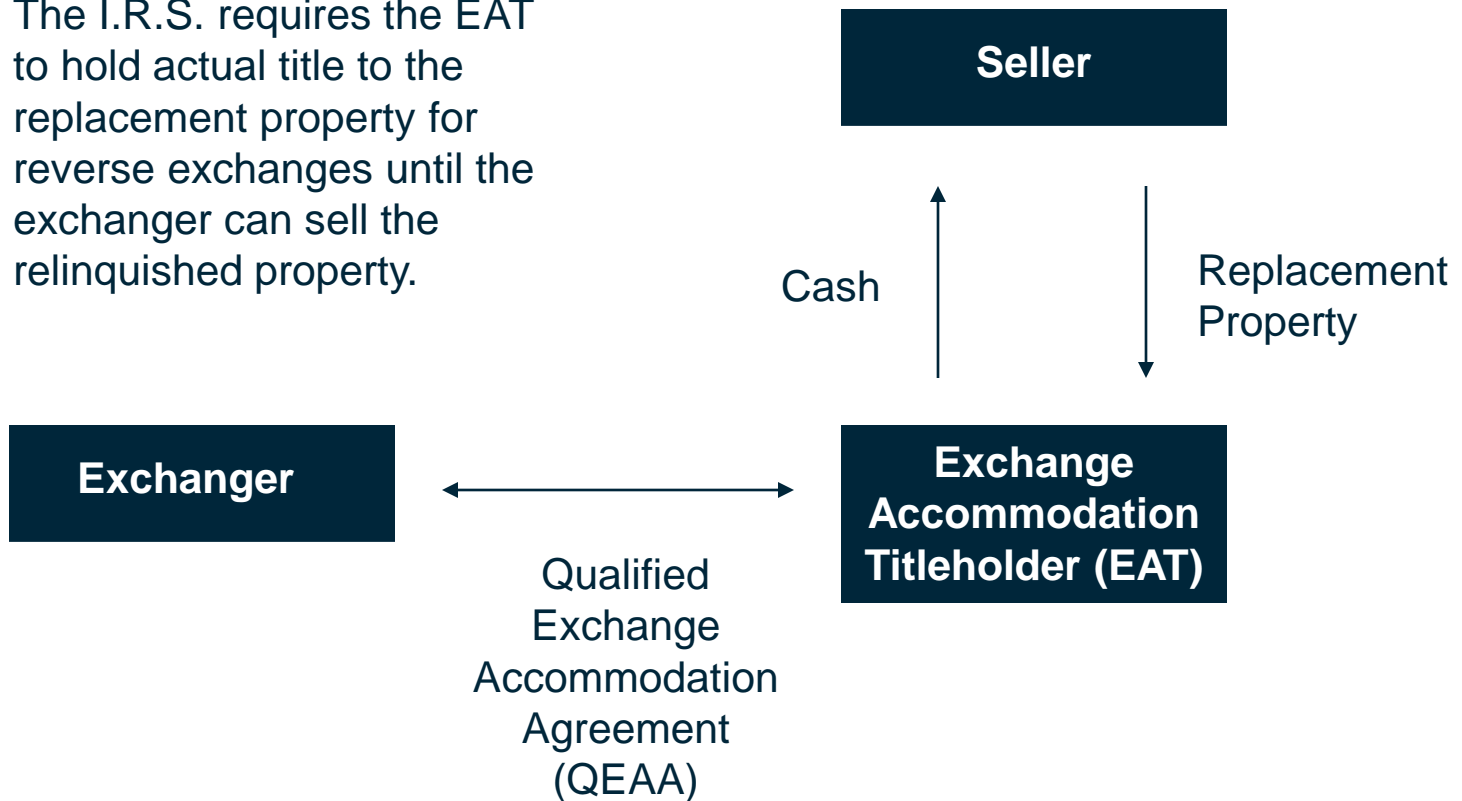
Red Flag: Not using Reverse and Improvement Exchanges

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: Replacement Property Parked (Phase One)

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.



Constructing Improvements

- Must be done before property is acquired by Exchanger.
- Can be done by an Exchange Accommodation Titleholder (EAT) in an improvement exchange
- 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.
- Cannot be constructed by the exchanger after property is acquired.

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.

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”

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 Cont. (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 Cont. (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 Cont. (Swap and Drop)

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

Threats to Section 1031

- We learned in 2017 that a one party sweep always brings massive change in the tax code.
 - **Democratic threats:** Biden has called for the repeal of Section 1031, President Obama called for capping Section 1031 gains at \$1 million per year, per taxpayer; Capital gains mark-to-market, championed by Sen. Wyden (D-OR) and academics
 - Section 1031 is viewed by some as a "loophole," favoring the rich.

Use Us As Your Resource

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



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