<u>U.S. INTERNAL REVENUE CODE</u>
<u>SECTION 1031 TAX DEFERRED LIKE KIND EXCHANGES</u>

This outline has been modified to reflect the recent changes in the tax law.

I. SECTION 1031 LIKE KIND EXCHANGE

A. What is a 1031 tax deferred like kind exchange under IRC 1031 (hereinafter a "1031 Exchange" or "Section 1031 Exchange)?

1. Transaction where real property owner (the "Taxpayer") exchanges one property for another without incurring income tax on the gain.

2. Must structure transaction as "exchange" of one property for another, as opposed to the sale of one property and the purchase of another.

3. Tax on the transaction is ***deferred*** until some future date (i.e., when the newly acquired property is sold).

B. Why is the exchange "tax deferred"?

1. IRC 1031 authorizes tax deferred exchanges.

2. IRS says so and has provided detailed regulations.

C. What are advantages of a 1031 Exchange?

1. Dispose of property without incurring immediate tax liability.

2. Use tax deferred dollars in another investment.

3. "Interest free loan" from the IRS.

4. Tax deferred exchange becomes tax free exchange upon Taxpayer's death, since Taxpayer's heirs receive property with basis "stepped up" to fair market value at time of death.

D. Are there any disadvantages of tax deferred exchanges?

1. Reduced basis in newly acquired property will result in more taxable gain when that property is sold.

2. Increased transactional costs, such as attorney fees, escrow fees and intermediary fees.

3. Taxpayer must apply proceeds from disposition of old property to acquisition of new property.

4. The IRC and IRS Regulations must be followed or the transaction will be subject to tax.

E. What are the elements of a tax deferred exchange?

1. Both the "Relinquished Property" (the old property being disposed of) and the "Replacement Property" (the new property being acquired) must be either:

   a. Held for productive use in a trade or business, or

   b. Held for investment; and

2. The Relinquished Property and Replacement Property must be of "like kind"; and

3. The exchange must be a reciprocal transfer of properties as opposed to a sale and purchase.

F. Must both properties be held either for productive use in a trade or business or for investment?

1. Yes.

2. Consider the use of each property by the Taxpayer, not other parties to transaction.

3. Apply test at time of exchange (prior motives not controlling).

4. Note: 1031 is not available for property held "primarily for sale" by a Taxpayer who is a "dealer" in real estate. Whether property is held by that Taxpayer primarily for sale is a question of fact.

G. How long must Taxpayer hold Replacement Property?

1. The answer here, too, is a question of fact: did the Taxpayer intend to hold the Replacement Property for use in a trade or business or for investment, or merely resell it?

2. Two (2) years is generally a safe holding period.

3. Shorter holding periods may be acceptable, depending upon the Taxpayer's true intent at the time of the exchange.

4. Be careful on transfers to limited liability companies or S corporations after the exchange if Relinquished Property was not held in that entity.

H. What is "like kind"?

1. All real estate.

2. May trade improved real estate for unimproved real estate.

3. As of December 22, 2017, under current proposed legislation, personal property will no longer qualify under Section 1031.

I. Must exchange occur at the same time?

   1. No.

   2. Delayed exchanges are acceptable ***IF*** all IRS requirements are satisfied.

J. What are the basic 1031 delayed exchange requirements?

   1. Use of Qualified (Exchange) Intermediary.

   2. 45 day identification period.

   3. 180 day completion period.

   4. Appropriate identification of properties.

   5. Appropriate documentation and implementation of exchange.

K. What is a Qualified Intermediary?

   1. An organization or individual that facilitates deferred exchange by contracting with Taxpayer to do the following:

      a. Acquire Relinquished Property from Taxpayer.

      b. Transfer Relinquished Property to Purchaser (IRC and IRS regulations permit Taxpayer to deed property directly to Purchaser).

      c. Receive and hold "sale" proceeds from Purchaser.

      d. Acquire Replacement Property from Seller.

      e. Disburse "purchase" proceeds to Seller.

      f. Transfer Replacement Property to Taxpayer.

   2. Taxpayer does not receive proceeds from the disposition of Relinquished Property; proceeds are paid directly to Qualified Intermediary, which uses proceeds to acquire Replacement Property.

   3. Most title companies have affiliates who act as exchange intermediaries, for a fee.

L. What is the 45 day identification period?

   1. Taxpayer has 45 days from disposition of Relinquished Property to identify Replacement Property.

   2. May identify up to three (potential) Replacement Properties without regard to fair market value ("Three-Property Rule") or any number of (potential) Replacement Properties as long as their aggregate fair market value does not exceed 200% of the fair market value of the Relinquished Property ("200% Rule").

3. Notice must be signed by Taxpayer and hand delivered, sent by certified mail, faxed or emailed to, and received by, Qualified Intermediary before end of 45 day period.

M. What is 180 day completion period?

1. Taxpayer must receive Replacement Property within 180 days of surrendering control of Relinquished Property, OR the date (including extensions) Taxpayer's tax return is due, whichever occurs first.

2. If exchange begins (i.e. Taxpayer surrenders Relinquished Property) after October 17, Taxpayer must extend tax return filing date beyond April 15 to avoid shortening 180 day period to complete exchange.

N. Generally, what type of documentation is required to satisfy 1031 requirements?

1. Purchase Agreement for Relinquished Property should reference the parties' intent to make transaction part of 1031 Exchange.

2. Purchase Agreement for Replacement Property should reference the parties intent to make transaction part of 1031 Exchange.

3. For deferred exchange, need Exchange Agreement with Qualified Intermediary.

4. Assignment of Purchase Agreement whereby Taxpayer assigns interest in Relinquished Property Purchase Agreement to Qualified Intermediary, and Purchaser of that property must consent to assignment.

5. Assignment of Purchase Agreement whereby Taxpayer assigns interest in Replacement Property Purchase Agreement to same Qualified Intermediary, and Seller of that property must consent to assignment.

6. Other documentation may be required, depending upon the specifics of the particular transaction.

O. Could exchange result in immediate recognition of gain?

1. Yes.

2. To avoid gain, Taxpayer must "trade even or up in equity and even or up in value."

3. To the extent Taxpayer receives money or other property, Taxpayer will have "recognized gain" or "boot".

4. Any errors in structuring, documenting or implementing the exchange could also cause the Taxpayer to recognize gain.

II. NEW CONSTRUCTION EXCHANGE

A. What is a New Construction Exchange?

A New Construction Exchange is when a Taxpayer uses an intermediary to acquire title to Replacement Property, and the Replacement Property is improved before the Taxpayer takes title.

B. What is an example of a New Construction Exchange?

1. Taxpayer disposes of Relinquished Property for $1,000,000.

2. At closing, funds are paid to Qualified Intermediary.

3. Taxpayer identifies and uses Qualified Intermediary or Exchange Accommodation Titleholder (EAT) to acquire title to pre-improved Replacement Property, using $600,000 of the $1,000,000 of exchange proceeds.

4. IRS Rev. Proc. 2000-37, 2000-2 C.B. 308 and related rules permit EAT to acquire and hold title to Replacement Property, lease Replacement Property to Taxpayer and hire Taxpayer to manage construction of improvements.

5. Taxpayer, as construction manager, supervises improvement of Replacement Property. All $400,000 of exchange proceeds are used to pay contractors to make improvements.

6. EAT deeds improved Replacement Property to Taxpayer within 180 days after Taxpayer closes on disposition of Relinquished Property.

7. If EAT takes title to Replacement Property using single member limited liability company, Taxpayer can acquire title to the Replacement Property indirectly by acquiring 100% of the membership interests of EAT.

C. The 45 day notice should identify the Replacement Property together with all anticipated newly constructed improvements.

D. The key date is when the Taxpayer takes title to Improved Replacement Property. Therefore, look to the value in place on the date the Taxpayer acquires title to improved Replacement Property.

III. REVERSE EXCHANGE

A. What is a 1031 "Reverse" Exchange?

1. Transaction where property owner (Taxpayer), in effect, acquires "Replacement" Property before disposing of "Relinquished" Property.

2. In other words, the Taxpayer can buy first, then sell.

B. How does taxpayer do a Reverse Exchange?

1. IRS Rev. Proc. 2000-37 provides safe harbor for Reverse Exchanges to qualify under Section 1031. Taxpayer must comply with its technical requirements.

2. Taxpayer must contract with an Exchange Accommodation Titleholder ("EAT") by entering into a Qualified Exchange Accommodation Arrangement ("QEAA") for purposes of holding the property and meeting other requirements of Rev. Proc. 2000-37.

C. What are the requirements of a QEAA?

1. The EAT must hold qualified indicia of ownership of the property at all times from the date of acquisition by the EAT until the property is transferred to the Taxpayer. Qualified indicia of ownership means legal title to the property, or other indicia of ownership so that the EAT is treated as beneficial owner of the property for legal and tax purposes.

2. When the EAT acquires title, it must be the Taxpayer's bona fide intent that the property be held by the EAT as either Replacement Property or Relinquished Property in a transaction intended to qualify as a Section 1031 Exchange.

3. Within 5 business days after the EAT acquires the property, the Taxpayer and the EAT must enter into a written agreement (QEAA) confirming that the EAT is holding the property for the benefit of the Taxpayer in order to facilitate a Section 1031 Exchange under Rev. Proc. 2000-37 and that the Taxpayer and EAT will report the acquisition, holding and disposition of the property accordingly.

4. The Taxpayer must identify the Relinquished Property within 45 days after the EAT acquires the Replacement Property. The Taxpayer may identify alternative and multiple properties, just like with a "straight" Section 1031 Exchange.

5. Within 180 days after the EAT acquires the property:

    a. The property must be transferred to the Taxpayer as Replacement Property; or

    b. The property must be transferred to an unrelated person as the Relinquished Property.

D. What permissible arrangements fall within the safe harbor?

1. Rev. Proc. 2000-37 provides for a number of permissible agreements which will not, in and of themselves, defeat the exchange.

2. The EAT may enter into an exchange agreement with the Taxpayer and serve as the Qualified Intermediary in a simultaneous or tax-deferred exchange.

3. The Taxpayer may guarantee some or all of the obligations of the EAT, including secured or unsecured debt incurred to acquire the property.

4. The Taxpayer may indemnify the EAT against costs and expenses.

5. The Taxpayer may loan funds to the EAT.

6. The Taxpayer may guarantee repayment of a third party loan to the EAT.

7. The Taxpayer may lease the property from the EAT.

8. The Taxpayer may manage the property, supervise improvements of the property, act as a contractor, or otherwise provide services to the EAT with respect to the property.

9. The Taxpayer and the EAT may enter into agreements relating to the purchase or sale of the property, including puts and calls at fixed or formula prices, for a period not exceeding 185 days from the date the EAT acquires the property.

E. Can there ever be a reverse, New Construction Exchange?

Yes, with proper planning.

IV. <u>SECOND OR VACATION HOMES</u>

Can a second or vacation home ever qualify for 1031 Exchange treatment?

A. IRS Rev. Proc. 2008-16, 2008-1 C.B. 547 provides a safe harbor for determining when a second or vacation home qualifies as property held for productive use in a trade or business or for investment, for purposes of a Section 1031 Exchange.

1. IRC 1031 provides that no gain or loss is recognized on the exchange of property held for productive use in a trade or business or for investment (Relinquished Property), if the property is exchanged solely for property of like kind that is to be held either for productive use in a trade or business or for investment (Replacement Property).

2. The IRS has made clear that a "personal residence" is not property held for productive use in a trade or business or for investment and, therefore, cannot qualify as part of a Section 1031 Exchange. Rev. Proc. 2005-14, 2005-7 I.R.B. 528; *Starker v United States*, 602 F.2d 1341, 1350 (9th Cir. 1979); and *Moore v Commissioner*, T.C. Memo. 2007-134.

3. Rev. Proc. 2008-16 provides Taxpayers with a safe harbor under which a dwelling unit will qualify as property held for productive use in a trade or business or for investment under Section 1031 even though a Taxpayer occasionally uses the dwelling for personal purposes.

B. What are Qualifying Use Standards for "Relinquished Property"?

1. The dwelling unit must be owned by the Taxpayer at least 24 months immediately before the exchange (the "qualifying use period"); and

2. Within the qualifying use period, in each of the two 12-month periods immediately preceding the exchange:

a. The Taxpayer rents the dwelling unit to another person(s) at a “fair rental” for 14 days or more, and

b. The period of the Taxpayer’s personal use of the dwelling does not exceed the greater of 14 days or 10% of the number of days during the 12-month period that the dwelling unit is rented at a fair rental.

C. What are Qualifying Use Standards for “Replacement Property”?

1. The dwelling unit must be owned by the Taxpayer for at least 24 months immediately after the exchange (the “qualifying use period”); and

2. Within the qualifying use period, in each of the two 12-month periods immediately after the exchange:

    a. The Taxpayer rents the dwelling unit to another person(s) at a fair rental for 14 days or more, and

    b. The period of the Taxpayer’s personal use of the dwelling does not exceed the greater of 14 days or 10% of the number of days during the 12-month period that the dwelling unit is rented at a fair rental.

D. How is personal use defined?

Personal use is defined in IRC 280A(d)(2) and includes use by the Taxpayer, the Taxpayer’s family or a co-owner. Family includes Taxpayer’s spouse, brothers, sisters, ancestors and lineal descendants. There is an exception if a family member rents the property at fair market value *and* the family member uses the property as his or her principal residence.

E. How is fair rental value determined?

Fair rental is determined based on all the facts and circumstances that exist when the rental agreement is entered into.

F. Any Other Considerations?

A Taxpayer utilizing this safe harbor must also satisfy all other requirements for a Section 1031 exchange.

G. Even if a vacation property does not fall squarely within the safe harbor provided by Rev. Proc. 2008-16, it is still possible for a Taxpayer to establish that the property qualifies under Section 1031 as property held for productive use in a trade or business or for an investment.