



Teresa Person, CES®  
tperson@1031exchange.com

# Understanding the 1031 Exchange

# What is a 1031 Deferred Exchange?

- ▶ Historical Perspective
  - Original Tax Law
- ▶ Defers or Eliminates Tax on Capital Gains
  - “Gain or loss is not recognized when property held for use in trade or business or for investment, is exchanged for like-kind property to be held for use in trade or business or for investment.”



# Parties to the Exchange

- ▶ Taxpayer
- ▶ Real Estate Agents
- ▶ Attorneys
- ▶ Lenders
- ▶ CPAs
- ▶ Qualified Intermediaries
- ▶ Escrow Agents

# Role of the Qualified Intermediary

- ▶ Structure the Exchange
- ▶ Provide Proper Documentation
- ▶ Safeguard Funds
- ▶ Monitor Statutory Time Requirements
- ▶ Final Accounting
- ▶ Provide Replacement Property Options
- ▶ Advise on Investment
- ▶ Close the Transaction
- ▶ Tax Advice or Return

“DO”

“DON'T DO”

# What You Can/Can't Exchange

- ▶ Oil/gas/mineral interest
- ▶ Timber
- ▶ Perpetual Water Rights
- ▶ Un-harvested Crops
- ▶ Sale leaseback transactions
- ▶ Contracts for Deed
- ▶ Options to purchase
- ▶ Leasehold Interests 30+ yrs
- ▶ Livestock
- ▶ Easements
- ▶ Development Rights
- ▶ Property held primarily for sale
- ▶ Stocks, bonds or notes
- ▶ REITs
- ▶ Interest in Partnerships
- ▶ Choses in Action – Right to receive or recover money, consideration or property from another.
  - Courts contend they are not property
  - Look to States for definition

Can Be Exchanged

Cannot Be Exchanged

# Requirements of an Exchange

1. Must be Investment, Business or Income Property
2. Must Exchange for Property of a “Like-Kind”
3. Must Properly Document as an Exchange

# Must Properly Document as an Exchange

- ▶ Contract Addendum



## Contract Addendum for Replacement Property

**Seller:** \_\_\_\_\_

**Buyer:** \_\_\_\_\_

**Property Description/Street Address:** \_\_\_\_\_

### Terms of Addendum

This addendum contains additional terms of and shall be a part of the contract between Buyer and Seller for the purchase and sale of the Property.

Seller acknowledges notification that:

(a) Buyer intends to purchase the Property as part of a tax deferred exchange of property under the provisions of Section 1031 of the Internal Revenue Code of 1986 ("the Code") and applicable regulations promulgated by the Internal Revenue Service ("IRS").

(b) Buyer has entered into a contract with 1031 Exchange Corporation to serve as a qualified intermediary in the contemplated exchange of property.

Buyer identifies the Property as the property Buyer desires to acquire to replace the property Buyer has previously relinquished as part of a tax deferred exchange.

Seller agrees to cooperate with Buyer in completing this transaction in compliance with the requirements of Section 1031 of the Code provided Seller does not incur any additional expense.

To comply with IRS regulations, Buyer will assign this contract to 1031 Exchange Corporation. However, Buyer has elected to receive a direct conveyance of the Property from Seller. Seller agrees to permit an assignment of this contract to 1031 Exchange Corporation for the purpose of allowing Buyer to comply with IRS regulations.

If the terms of this addendum conflict with the terms contained in the body of the contract, whether printed, typewritten, handwritten or contained in any other addendum to the contract, the terms of this addendum shall control.

# Must Properly Document as an Exchange

- ▶ Contract Addendum
- ▶ Special Provisions

within 7 days after the Effective Date of the contract.

11. **SPECIAL PROVISIONS:** (Insert only factual statements and business details applicable to the sale. TREC rules prohibit license holder from adding factual statements or business details for which a contract addendum, lease or other form has been promulgated by TREC for mandatory use.) **Seller to cooperate with buyer in a 1031 tax deferred exchange at no cost to seller.**

# Must Properly Document as an Exchange

- ▶ Contract Addendum
- ▶ Special Provisions
- ▶ TREC Commercial Contract

G.  Seller  Buyer intend(s) to complete this transaction as a part of an exchange of like-kind properties in accordance with Section 1031 of the Internal Revenue Code, as amended. All expenses in connection with the contemplated exchange will be paid by the exchanging party. The other party will not incur any expense or liability with respect to the exchange. The parties agree to cooperate fully and in good faith to arrange and consummate the exchange so as to comply to the maximum extent feasible with the provisions of Section 1031 of the Internal Revenue Code. The other provisions of this contract will not be affected in the event the contemplated exchange fails to occur.

# IRS Form 8824

- ▶ Exchanges over Two Tax Years
- ▶ Does not Delay Tax Liability
- ▶ Calculation of Gain Worksheet

The image shows the IRS Form 8824 (2015) titled "Like-Kind Exchanges (and section 1043 conflict-of-interest sales)". The form is for the year 2015 and is an attachment to Form 1099. It is used to report the details of a like-kind exchange of property. The form is divided into two main parts: Part I, "Information on the Like-Kind Exchange," and Part II, "Related Party Exchange Information." Part I includes fields for the description of the property given up and received, the dates of acquisition and transfer, and whether the exchange was with a related party. Part II includes fields for the name and relationship of the related party, and whether the exchange was with a related party. The form also includes a note about filing the form if a related party sold property into the exchange, and a section for reporting exceptions to the related party rule.

**Form 8824** Like-Kind Exchanges (and section 1043 conflict-of-interest sales) OMB No. 1545-1190  
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](http://www.irs.gov/form8824). **2015** Attachment Sequence No. 109

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

**Note:** Do not file this form if a related party sold property into the exchange, directly or indirectly (such as through an intermediary); that property became your replacement property; and none of the exceptions in line 11 applies to the exchange. Instead, report the disposition of the property as if the exchange had been a sale. If one of the exceptions on line 11 applies to the exchange, complete Part II.

**Part II Related Party Exchange Information**

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

Address (no., street, and apt., room, or suite 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? . . . . .  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).

For Paperwork Reduction Act Notice, see the instructions. Cat. No. 12311A Form **8824** (2015)

# Advantages to Exchanging

- ▶ Consolidate or Diversify Investments
  - Reduce/Increase Number of Units
  - Move to Various Types of Units
- ▶ Relocation of Investment
- ▶ Leverage Appreciation
- ▶ Greater Cash Flow
  - Raw Land vs. Income Property
- ▶ Can be an Important Part of Estate Planning

# Disadvantages to Exchanging

- ▶ Reduced Basis in Replacement Property
- ▶ Increase in Transactional Costs
  - Exchange Fee
- ▶ Limitation on use of Equity

# Adjusted Basis in Replacement Property

- ▶ Value of Replacement Property
- ▶ Amount of gain recognized, not realized (deferred) in the exchange
- ▶ Called “Carryover” tax basis

Cost of Replacement Property	\$1,500,000.00
<i>minus</i> Deferred Gain	\$ 259,500.00
<i>Equals</i> New Basis	\$1,240,500.00

Replacement Property

# Possible Tax Consequences Even With An Exchange

- ▶ Exchange Expenses
  - Hard Closing Costs
    - Commissions, Policy Premiums
- ▶ Transactional Costs – Non Exchange Expense
  - Non Qualifying Exchange Expenses
    - Utilities, Tax Prorations, Lender Costs, HOA
- ▶ Liabilities
  - Secured or Unsecured
- ▶ Seller Financing



# CURRENT TAX RATES

- ▶ Expiration of tax cuts caused a substantial increase in federal income taxes for most taxpayers!

- ▶ Capital Gains Tax

15%-20%

- Adjusted Gross Income greater than \$450K/\$400K

- ▶ Surtax for Affordable Care Act

+ 3.8%

- ▶ Applies to Net Investment Income

- To the extent in excess of \$250K/\$200K
- Does not include gains from sale of properties used in the ordinary course of business, unless the properties are a “Passive Activity”
- AGI \$250,000/\$125,000/\$200,000
- Doesn’t apply to C Corporations
- 1031 Exchanges will also allow for deferral of this tax

- ▶ Ordinary Income Tax

Increased to 39.6%

# Capital Gain Tax Calculation

## 1. Calculate Net Adjusted Basis:

Original Purchase Price:	\$695,000.00
<i>plus</i> Improvements:	\$100,000.00
<i>minus</i> Depreciation:	\$144,500.00
<i>Equals</i> NET ADJUSTED BASIS	<b>\$650,500.00</b>

## 2. Calculate Capital Gain:


Sales Price	\$975,000.00
<i>minus</i> Net Adjusted Basis	\$650,500.00
<i>minus</i> Cost of Sale	\$ 65,000.00
<i>Equals</i> CAPITAL GAIN	<b>\$259,500.00</b>

## 3. Calculate Tax Due:

Recapture Depreciation (25%)	\$ 36,125.00
<i>plus</i> Tax Rate (x) Capital Gains	\$ 38,925.00
<i>plus</i> Medicare Surtax (x) Capital Gain	\$ 9,861.00
<i>Equals</i> TOTAL TAXES DUE	<b>\$ 84,911.00</b>

# Investment Benefits without Exchange

▶ Sales Price		\$500,000
▶ Less Costs of Sale		<u>50,000</u>
▶ Adjusted Sales Price		<u>\$450,000</u>
▶ Adjusted Basis		\$200,000
▶ Taxable Gain	$(\$450,000 - \$200,000) =$	\$250,000
▶ Depreciation Taken		\$45,000
▶ Tax on Disposition		
	$(\$250,000 \times 20\% \text{ plus } \$45,000 \times 25\%) =$	\$61,250
▶ Amount Remaining to Reinvest		
	$(\$450,000 - \$61,250) =$	<u>\$388,750</u>

A diagram consisting of two green arrows. The first arrow starts at the right side of the 'Adjusted Sales Price' row (\$450,000) and points down to the left side of the 'Taxable Gain' row. The second arrow starts at the right side of the 'Adjusted Basis' row (\$200,000) and points down to the left side of the 'Taxable Gain' row. This illustrates that the taxable gain is calculated as the adjusted sales price minus the adjusted basis.

# Investments Benefits with Exchange

▶ Sales Price	\$500,000
▶ Less costs of sale	<u>50,000</u>
▶ Proceeds	\$450,000

With an exchange, the tax is deferred allowing the full amount of proceeds to be reinvested. Assuming a 80% LTV ratio, an additional \$306,250.00 in property can be purchased

# What is the Impact on Depreciation?

- ▶ Reduced Tax Basis in Replacement Property
- ▶ 25% Recapture
  - Property Class
  - Could trigger ordinary income if gain is recognized
- ▶ Effect on Future/Current Depreciation
  - Unrecaptured vs. recaptured
  - Affects depreciation schedules

# Step Transaction Rule

- ▶ Placing Mortgages / Refinancing immediately before or after the exchange
- ▶ Changing Title Before and After the Exchange
  - Drop and Swaps
  - Single Member LLCs
  - Disregarded Entities

# Holding Periods

- ▶ Short Term vs Long Term Capital Gains Tax Rates
  - Short term hold periods can qualify
- ▶ Intent
  - Did you acquire immediately prior to sale
    - Held for a qualified purpose?
    - Dealer Property
- ▶ 1 and 2 year tolling periods
  - Resale
  - Occupy

# Related Sections in the Tax Code

- ▶ §121 – Principal Residence Exemption
  - No two year tolling period
  - No IRS forms to complete
    - \$250,000 for Single Filers
    - \$500,000 for Married Filers
  
- ▶ §1033 Condemnation/Involuntary Conversion
  - Must be credible and explicit threat
  - Tolling period of 2 or 3 years
    - For 2 Years – Similar or Related Use – same function rental/rental
    - For 3 Years – Like Kind Standard
  - No Intermediary Required
  - No Constructive Receipt Issues
  - Filing with IRS is Required
  - Can be on Land owned by Taxpayer



# Personal & Multiple Property Exchanges

- ▶ Personal Business Property
  - Like-Kind vs Like Class
  - Intangibles – only apply like-kind standard
    - Patents, copyrights, licenses, trademarks
  - Business Swaps
    - Consist of multiple asset groups
      - Asset by Asset
      - Like-Kind
    - Consists of some items that do not qualify
      - Goodwill
      - Covenant not to compete
      - Inventory

# Identification Rules

- ▶ Time Constraints
  - 45 days from date of closing to identify
  - 180 days from date of closing to complete exchange
- ▶ Multiple Properties
  - No limit to number of properties than can be sold or purchased
- ▶ Extensions Allowed
- ▶ Who Receives Designation



# Identification Rules

## ▶ Identification Options

- 3 Property Rule
- 200% Rule
- 95% Rule



## ▶ Describing Replacement Property

- Special Rules for Construction/Improvement Exchanges

## ▶ Time Periods for Multiple Sales in One Exchange

## ▶ “Substantially” Received

# Constructive Receipt Rules

- ▶ Part Sale and Part Exchange
  - Part Personal Use
- ▶ Taking Cash from Closing
  - Must be stated in 1031 Documents
  - Must be received from Title Company
- ▶ Receiving Earnest Money and Option Fees



# Release of Funds to Taxpayer

- ▶ At Sale of Relinquished Property
- ▶ On Day 46
  - After all Designated Properties are Purchased
  - No Properties are Designated
- ▶ Between Day 46 and 180
  - After all Designated Properties are Purchased
  - Exceptions
    - Modified Designation
    - Material and Substantial
- ▶ Day 181
  - Any remaining funds are returned to taxpayer
    - State Requirements

# Problems in Exchanging

- ▶ Taxable “Boot”
- ▶ Partnership and Co-Ownership Issues
  - Drop and Swap
    - Same Taxpayer Issues
    - Qualified Use Problems
    - Step Transaction
  - Co-tenancy versus Partnership
  - Corporations
- ▶ DSTs and TICs
  - Designation Complications
  - Often used as “last minute” bail out

# Special Exchange Issues

- ▶ Related Parties
- ▶ Equity versus Proceeds
- ▶ Building on land owned by taxpayer
  
- ▶ Vacation and Second Homes
  - Greater of 14 days or 10% of total time rented



# Other Types of Exchanges

- ▶ Deferred Exchange
  - Sale then Purchase
- ▶ Reverse Exchange
  - Purchase then Sale
- ▶ Construction/Build to Suit
- ▶ Reverse Construction





# Reverse and Improvement Exchanges

- ▶ Revenue Procedure 2000-37
- ▶ Requires use of EAT Parking Arrangement
  - Exchange Accommodation Titleholder
  - Can “Park” Relinquished or Replacement Property
    - Due on Sale Clause Considerations
  - Title Policy Requirements
  - Series LLC
- ▶ Identification Rules
  - Improvements



# Reverse and Improvement Exchanges

- ▶ Failed Reverse/Improvement Exchange
- ▶ Combination Reverse/Deferred
- ▶ Exchanges Outside the Safe Harbor

# Exchanges as an Estate Planning Tool

- ▶ Stepped Up Basis
- ▶ Becomes Primary Residence
  - Combination of §1031 and §121



# Estate Planning Benefits

Sales Price	\$ 400,000.00
Less Basis	<u>150,000.00</u>
Recognized Gain	\$250,000.00

## Left to Heirs:

Sales Price	\$400,000.00
Less Basis	<u>400,000.00</u>
Recognized Gain	\$ 0.00

## Heirs Hold Then Sale :

Sales Price	\$500,000.00
Less Basis	<u>400,000.00</u>
Recognized Gain	\$100,000.00

# What is on the horizon for 1031's

- ▶ Blueprint for Tax Reform – August 2017?
  - Replaces tax deferral for improvements with immediate expensing.
    - Unlimited loss carryforward
    - Encourages inflated value of improvements when purchased
    - Easy to “game” the system
  - Ignores land value – does not permit expensing
    - Farmers, Ranchers often have low basis property or count on exchange for income producing asset
    - Land represents approximately 30% of the value of commercial improved properties and 100% of agricultural land investments.
- ▶ Elimination – Repeal §1031 from the tax code
- ▶ No mention of change in tax rate

# Questions?



# THANK YOU!

- ▶ Please contact me anytime with questions about Tax Deferred Exchanges.
- ▶ [www.1031exchange corp.com](http://www.1031exchange corp.com)
- ▶ [tperson@1031exchange corp.com](mailto:tperson@1031exchange corp.com)