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CHICAGO DEFERRED EXCHANGE COMPANY

LIKE-KIND EXCHANGES: A PRACTITIONER'S GUIDE TO 1031S

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WHAT YOU WILL LEARN TODAY...

- Why Exchange?
- Statutory Requirements
- Critical Deadlines and Equity/Debt Rules
- Types of Exchanges
- Recent Cases/Government Affairs
- Partnership Issues
- The Role of the Qualified Intermediary

UNDERSTANDING IRS GUIDANCE - A BRIEF PRIMER

- **Regulations***: issued by the Internal Revenue Service and Treasury Department to provide *guidance for new legislation* or to address issues that arise with respect to existing IRC sections. Regulations interpret and give directions on complying with the law.
- **Revenue Ruling***: an official interpretation by the IRS of the Internal Revenue Code, related statutes, tax treaties and regulations. It is the IRS' conclusion on *how the law is applied to a specific set of facts*.
- **Revenue Procedure***: an official statement of a procedure that affects the rights or duties of taxpayers or other members of the public under the IRC, related statutes, tax treaties and regulations and that should be a matter of public knowledge. While a revenue *ruling generally states an IRS position, a revenue procedure provides return filing or other instructions concerning an IRS position*.

*source: www.irs.gov

- **Private Letter Ruling* (PLR):** a written statement issued to a taxpayer that interprets and applies tax laws to the taxpayer's specific set of facts. A PLR is issued to establish with certainty the federal tax consequences of a particular transaction before the transaction is consummated or before the taxpayer's return is filed. A PLR is issued in response to a written request submitted by a taxpayer and is ***binding on the IRS if the taxpayer fully and accurately described the proposed transaction*** in the request and carries out the transaction as described.

*source: www.irs.gov

- **Technical Advice Memorandum* (TAM):** *guidance furnished by the Office of Chief Counsel upon the request of an IRS director* or an area director, appeals, in response to technical or procedural questions that develop during a proceeding. A request for a TAM generally stems from an examination of a taxpayer's return, a consideration of a taxpayer's claim for a refund or credit, or any other matter involving a specific taxpayer under the jurisdiction of the territory manager or the area director, appeals. TAMs are issued only on closed transactions and provide the interpretation of proper application of tax laws, tax treaties, regulations, revenue rulings or other precedents. The advice rendered represents a final determination of the position of the IRS, but only with respect to the specific issue in the specific case in which the advice is issued.

*source: www.irs.gov

- **Announcement***: a public ***pronouncement that has only immediate or short-term value***. For example, announcements can be used to summarize the law or regulations without making any substantive interpretation; to state what regulations will say when they are certain to be published in the immediate future; or to notify taxpayers of the existence of an approaching deadline.
- **Notice***: a public ***pronouncement that may contain guidance that involves substantive interpretations of the Internal Revenue Code or other provisions of the law***. For example, notices can be used to relate what regulations will say in situations where the regulations may not be published in the immediate future.

*source: www.irs.gov

INTERNAL REVENUE CODE SECTION 1031

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

IRC SECTION 1031

FOUR GENERAL STATUTORY REQUIREMENTS

- Properties must be ***real*** property
- Properties must be ***like-kind*** to each other
- Properties must be ***held for business or investment use***
- The transaction must be structured as an ***exchange***

BENEFITS OF A SECTION 1031 EXCHANGE

Tax Deferral

- 20% Federal Capital Gain Tax for assets held > 1 year
- 25% Federal Depreciation Recapture Tax
- State Income Taxes (if applicable)
- 3.8% Medicare Tax on net investment income

Other Advantages of Exchanging

- Diversification
- Consolidation
- Greater cash flow
- Estate planning

TREASURY REGULATIONS, EFFECTIVE DECEMBER 2020

DEFINING REAL PROPERTY FOR SECTION 1031

- Three alternative tests to determine real property under 1031
 - State Law Test
 - Defined as real property under state or local law in which the property is located
 - Listed Assets Test
 - Land
 - Improvements to land: inherently permanent structures or structural components or inherently permanent structures, water and air space super-adjacent to land
 - Factors Test
 - Consider the manner the structure is affixed
 - Was the structure designed to be removed or remain in place
 - Would the structure suffer damage if removed
 - Circumstances suggesting affixation is not indefinite
 - Time and expense required to remove structure

Using Relinquished Property Proceeds to Acquire Personal Property

Personal property is incidental to real property acquired in an exchange if, in standard commercial transactions, the personal property is typically transferred together with the real property, and the aggregate fair market value of the incidental personal property transferred with the real property does not exceed 15 percent of the aggregate fair market value of the replacement real property

Incidental personal property is still not real property and taxable boot if paid for with exchange proceeds

QUALIFYING PROPERTY

- Properties that **DO** Qualify

- Real property held for investment, income, or a trade or business, and ***not primarily for sale***.
- Rental homes/condos/**coops**
- Vacant land
- Retail
- Industrial/Warehouse
- Office
- Agricultural land/farms & ranches
- 30 Year Leasehold Interests
- Delaware Statutory Trusts
- Net lease property (triple-net or NNN)
- Easements/**development rights**
- **Options**
- **License/permit for use/enjoyment or occupation of land**

- Properties that **DO NOT** Qualify

Stock in trade or other ***real property held primarily for sale***.

- ***Stocks, bonds, notes***
- ***Other securities or evidences of indebtedness or interest***
- ***Certificates of trust or beneficial interests***
- ***Choses in action***
- Partnership Interests
- Primary Residence
- Personal Property (artwork etc.)

Property must be held for **investment** or for **use in a trade or business** in which the Taxpayer is engaged.

Business use property may be exchanged for investment property.

How does a Taxpayer establish investment or business use intent:

Look at facts and circumstances and Taxpayer's behavior

Consider Taxpayer's risk tolerance

- In **Bolker v. Commissioner**, 760 F.2d 1039, 1045 [56 AFTR 2d 85-5121] (9th Cir. 1985), affg. 81 T.C. 782 (1983), the court stated that:

“a taxpayer may satisfy the “holding” requirement by owning the property, and the “for productive use in trade or business or for investment” requirement by **lack of intent either to liquidate the investment or to use it for personal pursuits.**”

PLR 8429039 – two years of business or investment use is sufficient to meet the requirement that the property was held for the requisite intent.

Neal T. Baker Enterprises, Inc. v. Commissioner (1998) – Taxpayer exchanges 48 vacant lots after owning them for 11 years.

The exchange was disallowed, and the Taxpayer was deemed to have held the lots primarily “for sale”.

The lots were classified as “work in progress” on the Taxpayer’s books and the Taxpayer’s primary occupation was listed as “real estate sub-divider and developer.”

Adams v. Commissioner – T.C. Memo 2013-7 – below market rental

Patrick A. Reesink v. Commissioner, T.C. Memo 2012-18 – conversion to primary residence, eight months

Goolsby v. Commissioner, T.C. Memo 2010-64 – conversion to primary residence, two months

La Paloma Nevada Trust CA Office of Tax Appeals – taxpayers used the home as a primary residence as indicated by homeowner insurance and mortgage documents

Revenue Procedure 2008-16 – second home/vacation home

EXCHANGE REQUIREMENT

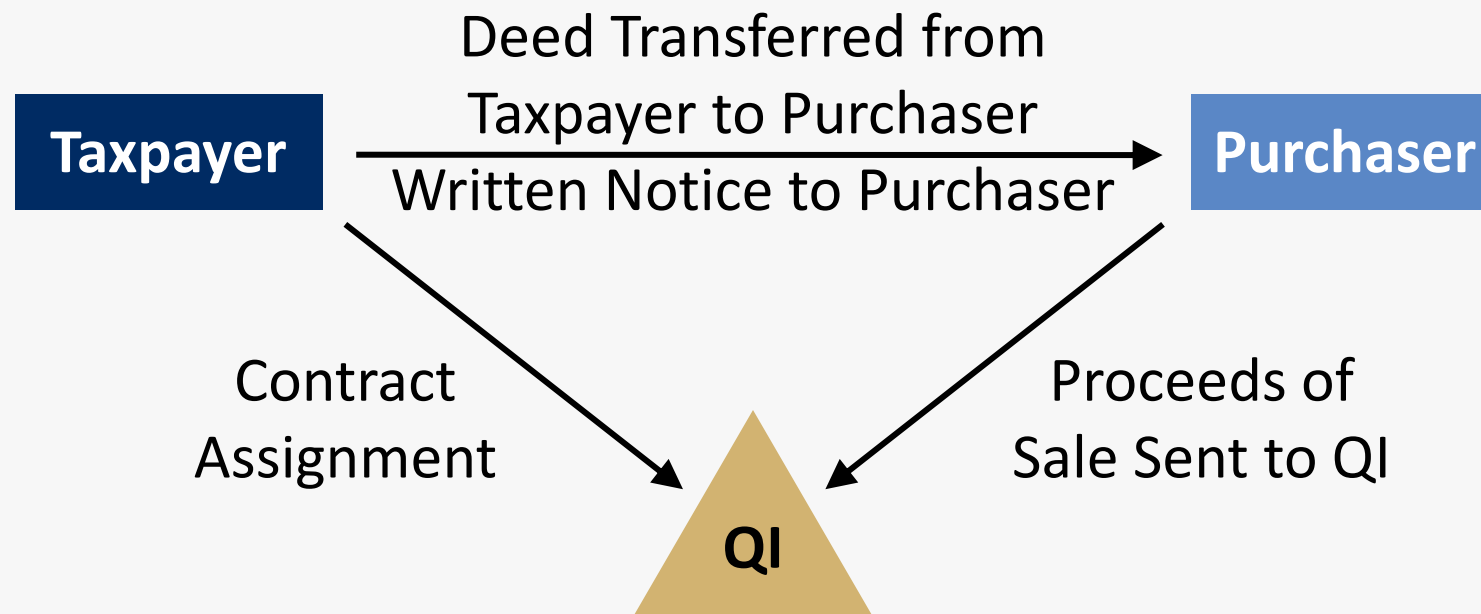
The Exchange must be structured as a reciprocal transfer of one property for another as distinguished from a sale followed by a purchase.

The Taxpayer may not **actually or constructively** receive the proceeds of sale.

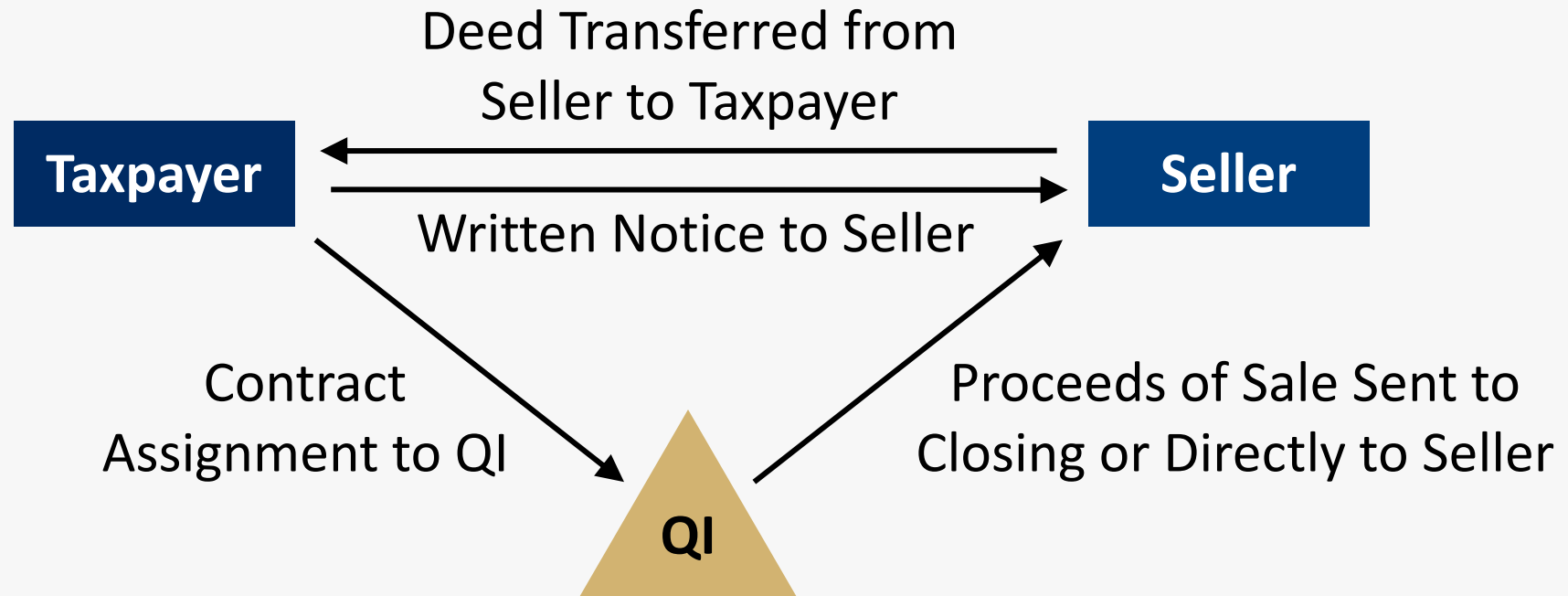


TAM 200130001 – failure to comply with the safe harbor requirement that the QI “acquires and transfers” the property results in the disqualification of an exchange.

Transfer of Relinquished Property



Acquisition of Replacement Property



Back of the Envelope Calculation

- All cash proceeds from the sale of the Relinquished Property must be reinvested in the Replacement Property (or pay tax on the difference);
- All debt paid off at Closing from the sale of the Relinquished Property must be replaced (or pay tax on the difference) – new equity can offset debt;
- The purchaser of the Replacement Property must be the same as the seller of the Relinquished Property, or be a “Disregarded Entity”

WHY DO A SECTION 1031 TAX-DEFERRED EXCHANGE

Relinquished Property Facts

Original Purchase Price:	\$2,000,000
Plus: Capital Improvements:	\$ 500,000
Less: Depreciation Deductions:	\$ 300,000
Adjusted Cost Basis:	\$2,200,000
Current Sale Price:	\$4,000,000
Realized Gain:	\$1,800,000

WHY DO A SECTION 1031 TAX-DEFERRED EXCHANGE

Assume an investor sells property for \$4,000,000 that is unencumbered:

1031 Exchange

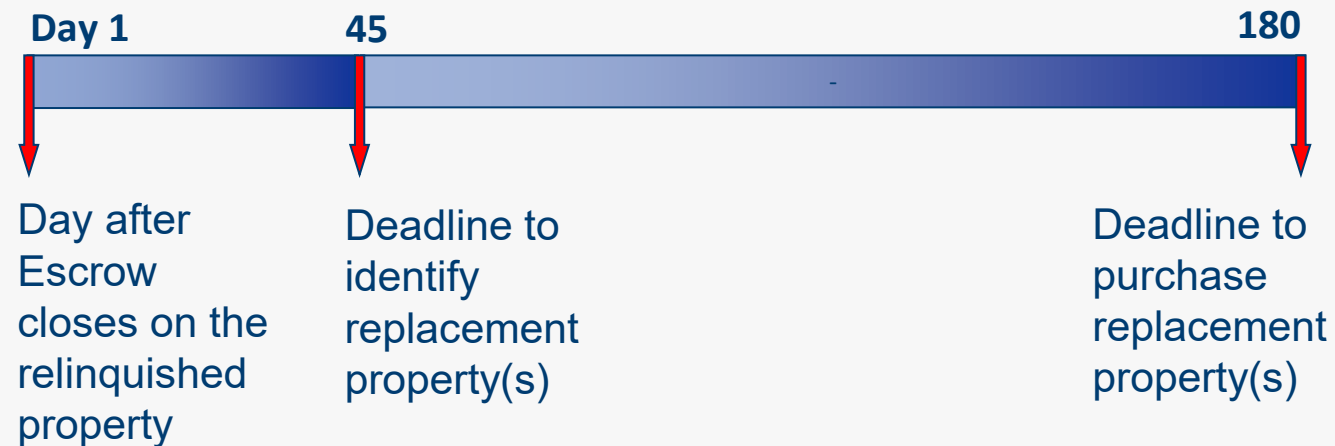
Sale FMV:	\$4,000,000
Closing Expenses:	\$ (200,000)
Net Proceeds to Taxpayer:	\$3,800,000
Replacement Property FMV:	\$3,800,000
Taxes Deferred:	\$ 491,800
Potential Tax:	\$ 0

Taxable Sale

Original Purchase Price:	\$2,000,000
Plus: Capital Improvements:	\$ 500,000
Less: Depreciation Deductions:	\$ 300,000
Adjusted Cost Basis:	\$2,200,000
Current Sale Price:	\$4,000,000
Realized Gain:	\$1,600,000
Potential Tax:	
Capital Gain (20%)	\$ 260,000
Depreciation Recapture (25%)	\$ 75,000
State Income Tax (assume 6%0	\$ 96,000
Net Investment Income Tax (3.8%)	\$ 60,800
Total Tax Due:	\$ 491,800

IRC SECTION 1031 EXCHANGE TIME PERIODS

The 1031 Exchange critical deadlines (45/180 calendar days) begin the day after escrow closes/title passes on the relinquished property.



An “**Affected Taxpayer**” includes individuals who live, and businesses whose principal place of business is located in, the Covered Disaster Area. Affected Taxpayers are entitled to relief regardless of where the relinquished property or replacement property is located. Affected Taxpayers may choose either the General Postponement relief under Section 6 OR the Alternative relief under Section 17 of Rev. Proc. 2018-58. Taxpayers who do not meet the definition of Affected Taxpayers do not qualify for Section 6 General Postponement relief.

DISASTER EXTENSIONS AND IRC SECTION 1031



Option One

General Postponement under Section 6 of Rev. Proc. 2018-58 (Affected Taxpayers only).

Any 45-day deadline or 180-day deadline (for either a forward or reverse exchange) that falls on or after the Disaster Date above is postponed to the General Postponement Date.

The General Postponement applies regardless of the date the Relinquished Property was transferred (or the parked property acquired by the EAT) and is available to Affected Taxpayers regardless of whether their exchange began before or after the Disaster Date.



Option Two

Section 17 Alternative (Available to (1) Affected Taxpayers and (2) other taxpayers who have difficulty meeting the exchange deadlines. See Rev. Proc. 2018-58, Section 17 for conditions constituting “difficulty”).

Option Two is only available if the relinquished property was transferred (or the parked property was acquired by the EAT) on or before the Disaster Date. Any 45-day or 180-day deadline that falls on or after the Disaster Date is extended to THE LONGER OF: (1) 120 days from such deadline; OR (2) the General Postponement Date.

IDENTIFICATION OF REPLACEMENT PROPERTY

- **3 Property Rule**
Without regard to FMV
- **200% Rule**
Aggregate FMV not to exceed 200% of RQ FMV
- **95% Rule**
Acquire 95% of FMV of identified property



STRUCTURING A FORWARD EXCHANGE – IDENTIFYING REPLACEMENT PROPERTY

Replacement Property must be designated as such **in written document signed by taxpayer** and hand delivered, mailed, telecopied, or otherwise sent before the end of the identification period to either:

- (1) person obligated to transfer Replacement Property to the taxpayer regardless of whether that person is disqualified; or
- (2) any other person involved in the exchange other than the taxpayer or disqualified person.

Negligence penalty and/or fraud penalty under IRC 6663; criminal charges for delivery of false documents (backdated letter).

Release of exchange funds - g(6) limits rights to receive, pledge, borrow or otherwise obtain benefits of money or other property before end of the exchange period.

RESTRICTIONS ON SAFE HARBORS:“(G)(6)” RESTRICTIONS

The Taxpayer must not have the right to receive, pledge, borrow, or otherwise obtain the benefit of the money or other property until:

If a replacement property has been identified but not received, the Taxpayer will only not be considered “entitled” to the proceeds if a material and substantial contingency related to that property has occurred which:

- Relates to the exchange;

- Is provided for in writing; and

- Is beyond the control of the taxpayer or a disqualified person.

BOOT: NON-LIKE-KIND PROPERTY RECEIVED BY THE TAXPAYER IN AN EXCHANGE THAT CAUSES GAIN RECOGNITION

Relinquished Property

FMV: \$1,500,000

Debt: \$ 500,000

Equity: \$1,000,000

Replacement Property

FMV: \$1,500,000

Debt: \$ 500,000

Equity: \$1,000,000

Taxpayer has re-invested all equity AND acquired replacement property of equal or greater value.

No boot and no recognized gain.

BOOT: NON-LIKE-KIND PROPERTY RECEIVED BY THE TAXPAYER IN AN EXCHANGE THAT CAUSES GAIN RECOGNITION

Relinquished Property

FMV: \$1,500,000

Debt: \$ 500,000

Equity: \$1,000,000

Replacement Property

FMV: \$1,500,000

Debt: \$ 750,000

Equity: \$ 750,000

\$250,000 of equity is not spent on replacement property.

Taxpayer receives cash boot of \$250,000 and recognizes gain on the cash received.

BOOT: NON-LIKE-KIND PROPERTY RECEIVED BY THE TAXPAYER IN AN EXCHANGE THAT CAUSES GAIN RECOGNITION

Relinquished Property

FMV: \$1,500,000

Debt: \$ 500,000

Equity: \$1,000,000

Replacement Property

FMV: \$1,250,000

Debt: \$ 0

Equity: \$1,000,000

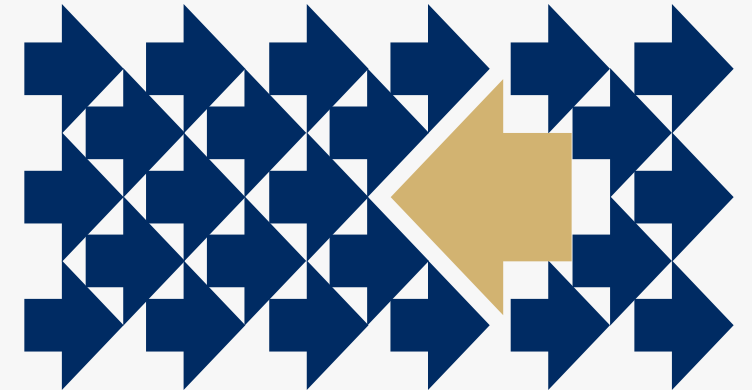
+ Cash: \$ 250,000

Taxpayer trades down in FMV by \$250,000 and net mortgage boot of \$250,000.

Revenue Procedure 2000-37

A safe harbor for “Parking Arrangements”

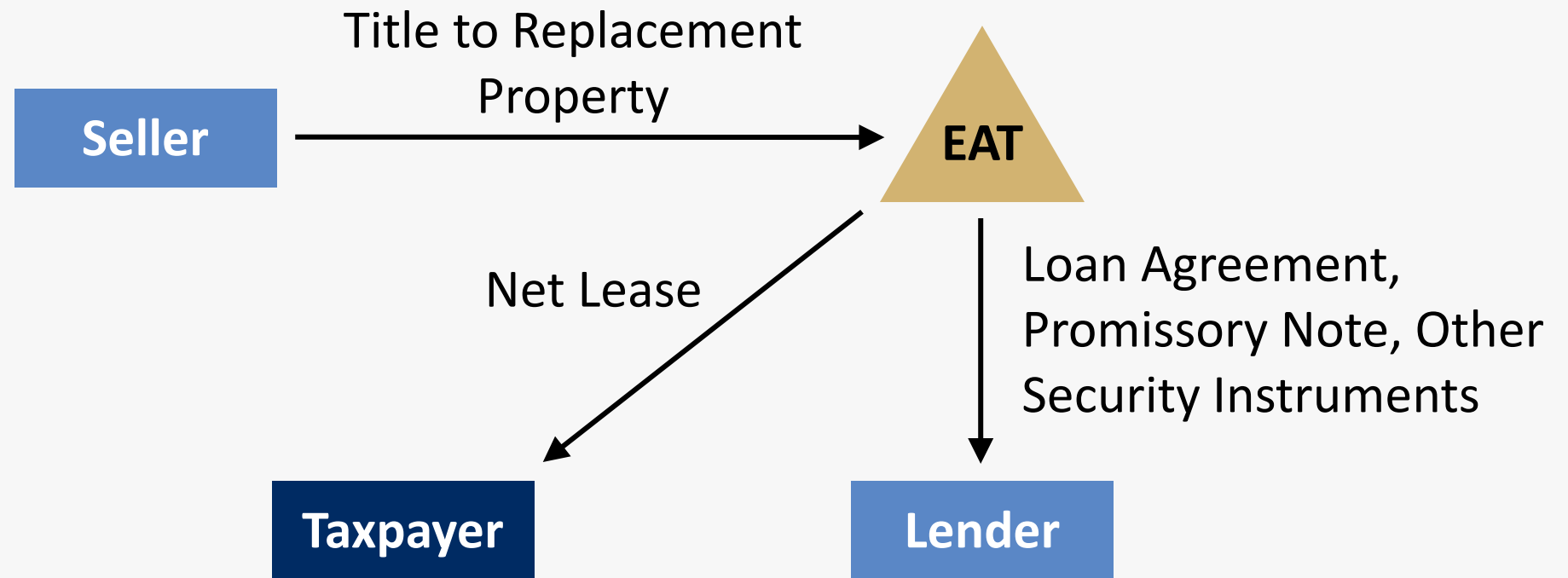
This Rev. Proc. provides a safe harbor under which the IRS will not challenge the qualification of relinquished property or replacement property in certain “reverse exchanges.”



BENEFITS OF A REVERSE EXCHANGE

- ❑ Be an opportunistic buyer
- ❑ No loss in cash flow by selling existing property first
- ❑ Move your business to new location without interruption of existing business
- ❑ Construct improvements or rehab replacement property during the parking period

Acquisition of Replacement Property by EAT



A Qualified Intermediary is an unrelated third party who is not the Taxpayer or a Disqualified Person who acts to facilitate a deferred exchange.

- 1. The QI becomes the party with whom the Taxpayer exchanges its properties;**
2. The QI uses a bank account, an escrow account or a trust account to help the Taxpayer avoid the issue of constructive or actual receipt of the sale proceeds;
3. The QI provides the Taxpayer with all of the documentation required to structure the exchange as a safe harbor transaction.

A “Disqualified” Person is anyone who is:

The **agent of the taxpayer** at the time of the transaction.

Has acted as taxpayer’s **employee, attorney, accountant, investment banker, real estate agent, or broker within the two-year period** ending on the date of the transfer of relinquished property.

Is “related” to the taxpayer as described in IRC Section 267(b) or Section 707(b) determined by substituting **10% for 50%** each place it appears.

Bears same relationship with person described in third bullet point.

BENEFITS OF WORKING WITH CDEC



Security

Your money is safe with CDEC. We create a separate trust account for every client on every transaction. CDEC is a subsidiary of Wintrust Financial Corporation—a \$56 billion financial services company.

Expertise

IRC Section 1031 Exchanges are our only business. CDEC has received several rulings from the IRS and other tax authorities that are helpful to our clients.

Service

Investors need to work closely with their QI. Our team brings 30 years of experience to provide unmatched expertise, security and integrity in every transaction.

Experience

An investor relies on the QI to properly document and facilitate the 1031 Exchange. Our core team has been together for over 25 years and has completed more than 75,000 transactions nationwide. We are always happy to be a resource.

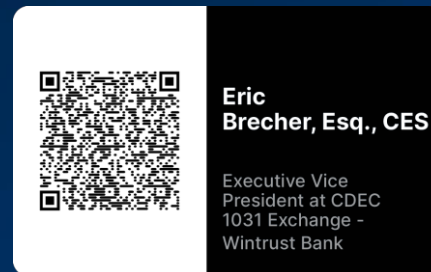
—— Thank you for attending! ——

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