

1031 Soup to Nuts

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INTRODUCTION

TERMINOLOGY

§1031/Delayed/Tax-Deferred/Tax Free/Like Kind/Starker – Internal Revenue Code (I.R.C.)

Section 1031 allows an owner of property held for productive use in a trade or business, or for investment, to defer payment of taxes on gain realized in the sale if they exchange for like-kind property. The tax is deferred (but not avoided) by transferring the basis in the relinquished property to the replacement property.

Exchanger – The Taxpayer completing the exchange.

Accommodator - The entity facilitating the exchange for the Exchanger. Some companies use the term “facilitator.” The Treasury Regulations use the term “qualified intermediary” (“QI”).

Relinquished property - The property “sold” by the Exchanger. Also called the “exchange” property or the “downleg.”

Replacement property - The property acquired by the Exchanger. Also called the “acquisition” property or the “upleg.”

Boot – Anything the Exchanger receives out of the exchange that is not like kind. (For example, cash, debt relief, non-qualified property.)

Appetizers

Don't Want to Pay Capital Gain Taxes?

The primary purpose of an exchange is the ability to defer the payment of State and Federal capital gain taxes.

STORY: Client paid \$110k for five acres on the edge of town in 1979. They are now selling to Intel for \$1.3m.

Don't Want to Pay Depreciation Recapture?

The Exchanger can also defer payment of depreciation recapture.

STORY: Client is selling a rental condo in Reno for the same price they paid 19 years ago. They have no capital gain but they have 19 years of depreciation deductions.

Soup

LIKE-KIND PROPERTY

The best feature of an exchange. **All real property is like-kind with all other real property.** This flexible rule allows the Exchanger to dramatically change their real estate portfolio in addition to obtaining a tax deferral. Two categories of property qualify for exchange treatment:

1. Property held for **investment**, or
2. Property held for productive use in a **trade or business**.

STORY: Sell bare land for income property.

STORY: Sell a rental house to buy a strip mall.

STORY: Sell a rental at the beach to buy a rental in Phoenix that will eventually be used for retirement.

Non-qualified property - Unfortunately, two categories of property **do not qualify** for exchange treatment.

1. Property held for personal use. This may be the second home or vacation property.
2. Property held primarily for sale. These would be the typical builder/developer properties and rehab properties.

STORY: The Taxpayer sells a rental and buys a “rental.” After two months of “trying” to rent (and also renovating), the Taxpayer is unable to come up with a tenant and decides to move in.

Goolsby v. Commissioner, T.C. Memo 2010-64 (4/1/10)

STORY: The Taxpayer buys a bank-owned property to fix and sell.

Entrée

DEADLINES

The deadlines begin to run on the date the Exchanger transfers the relinquished property to the buyer. The date of transfer will be the date of recording or the date the Buyer takes the benefits and burdens of ownership, whichever occurs first.

1. **45-Day Rule** - The Exchanger must identify the potential replacement property within the first 45 days.

STORY: The client faxes the ID at 12:03 a.m. the morning of the 46th day.

2. **180-Day Rule** - The exchange period is 180 days or the date the Exchanger must file their tax return (including extensions), whichever occurs first. The Exchanger must acquire the replacement property within this period of time.

STORY: The Exchanger identifies new construction. Due to weather delays, hunting delays, etc. the Builder cannot complete the house within the timeframe.

3. There is no extension for Saturdays, Sundays, or holidays. Extensions will be available in the event of a federally-declared disaster.

STORY: The 180th day falls on Monday, Memorial Day. The client needs to close the purchase the Friday before.

STORY: The New York client's 180-day deadline falls on the week Superstorm Sandy hits.

4. If there is more than one relinquished property in the exchange and the sales of the properties occur on different dates, the 45 and 180-day periods are calculated from the first sale transaction that closes.

IDENTIFICATION RULES

1. **3-Property Rule** - The Exchanger may identify three (3) properties of any value (The vast majority of Exchangers are required to use this rule.), or
2. **200% Rule** - The Exchanger may identify more than three (3) properties if the total fair market value of what is identified does not exceed 200% of the sale price of the relinquished property(ies), or
3. **95% Rule** - If the Exchanger exceeds the 3-Property Rule and the 200% Rule the exchange will not fail if they purchase 95% of the aggregate fair market value of all identified properties.

STORY: The Exchanger sold a single-family rental in San Francisco for \$1.2m and wanted to purchase 10 – 11 \$100k rentals in Las Vegas.

IDENTIFICATION PROCESS

1. The identification must be delivered to a party to the exchange (i.e., the Accommodator).

STORY: “I delivered it to a security guard at another building on Sunday. Did you get it??”

2. It must be in writing.

STORY: The Exchanger on the phone saying, “Here, write this down.”

3. It must be “unambiguous.”

STORY: The identification comes in showing “1234 Main Street.” No city, no state.

4. It must be signed by the Exchanger.

STORY: The Exchanger sends an email and types their name at the bottom of the email.

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5. It must be delivered, mailed, telecopied, or “otherwise sent” within the 45 days.

STORY: The Exchanger identifies two properties within the 45 days and then about day 120 wants to fill in the third blank line.

BASIC RULES OF REINVESTMENT

In order to obtain the greatest benefit from an exchange the Exchanger must:

1. Use all the cash in the exchange account to acquire replacement property, and

STORY: The Exchanger needs to payoff credit card debt using some of the sale proceeds.

2. Have equal or greater debt on the replacement property, and

STORY: The Exchanger wants out from under debt so wants to buy free and clear replacement property.

3. Receive only like-kind property. (No airplanes, no carry-back.)

STORY: The Exchanger sells land and buys a farm with equipment.

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

PARTICIPATION OF EXCHANGE COMPANY

Treasury Regulations require the execution of exchange documents **prior to closing the sale** of the relinquished property. If closing occurs without exchange documents the result is a fully taxable sale. Assuming the Exchanger has already spoken with the exchange company, that company will simply need the name and phone number of the closer handling the transaction. The exchange

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company will call the closer to obtain a copy of the title commitment and a copy of the purchase and sale agreement. With this information the exchange company will prepare an exchange agreement and an assignment of the purchase and sale agreement. The exchange company typically delivers the original exchange documents to the closer who will obtain signatures at the time of closing – saving the Exchanger a trip to the exchange company office.

There continues to be misunderstanding surrounding the use of Accommodators in what is referred to as a “simultaneous” exchange. A sale to one party and purchase from another party, all on the same day, while seemingly “simultaneous”, is still a delayed exchange requiring the use of an Accommodator. The Accommodator is necessary to prevent the Exchanger from having “actual” or “constructive” receipt of the sale proceeds. Treas. Reg. §1.1031(k)-1(g)(4). Therefore, in a forward exchange, whether “simultaneous” or not, the Accommodator must be in place **prior to closing** on the relinquished property. Likewise, in a reverse exchange the Accommodator must be in place **prior to closing** on the replacement property.

STORY: “My sale closed last week.”

SIDES

LOOKING FOR REPLACEMENT PROPERTY

Given the very short timeframe of an exchange it is in the best interest of the Exchanger to get out looking for replacement property as early as possible. They may tie up a replacement property even before a buyer is found for the relinquished property. Of course, they need to make sure the closing of the replacement property is contingent on the closing of the relinquished property. With this advance work the Exchanger may be able to avoid the exchange deadlines altogether.

TAX AND LEGAL ADVISORS

Speaking with the tax and legal advisor is the only way the Exchanger will know if an exchange is beneficial. An exchange does not make sense if there is a **small amount of gain** in the relinquished property. Even when there is substantial gain in the listed property, there are numerous tax issues that could negate the need for an exchange. For example, they may have carry-forward **losses** and those losses could offset the gain from the sale.

The tax professional must also be consulted on particularly “creative” exchanges to confirm whether the tax professional is willing to sign the tax return. Under tax preparer penalty provisions the preparer will personally be subject to penalties, and possible discipline, if they sign a return without disclosing an aggressive tax strategy.

STORY: An agent discovered after completing her own exchange that the property she sold had a small loss.

EXCHANGE COMPANY

Experienced exchange personnel should be willing to explain exchange requirements to the Exchanger. In just a few minutes over the phone the exchange company should:

1. Ask about their overall plan for an exchange,
2. Educate them about the basic requirements for an exchange,
3. Identify exchange issues (related parties, vesting issues, etc.)

If the Exchanger decides to proceed with an exchange the exchange company will:

4. Prepared exchange documents for all closings.
5. Hold the proceeds from the sale until the time of purchase.

In 2007 the Treasury Inspector General for Tax Administration issued a report “Like-Kind Exchanges Require Oversight to Ensure Taxpayer Compliance” that raised the concern that some Taxpayers were attempting to exchange without the use of an accommodator. The IRS studied various aspects of like kind exchanges and issued a Fact Sheet (FS-2008-18) on like kind exchanges. Among other things this Fact Sheet emphasizes the requirement to use an accommodator stating, “You cannot act as your own facilitator.”

Crandall et al. v. Commissioner, T.C. Summ. Op. 2011-14 (2/15/11) - DIY Exchange

Frank J. Blangiardo v. Commissioner, T.C. Memo, 2014-110 (6/9/2014) – Attorney Son as QI

RETURNING EXCHANGE FUNDS TO THE EXCHANGER

The Exchanger can always get funds **before** the sale closes and certainly **after** the exchange concludes. But, they can never take funds during the exchange. There are only four termination

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events that permit the exchange company to return exchange funds to the Exchanger. Until one of the following events occurs the money must remain in the exchange account. Treas Reg §1.1031(k)-1(g)(6).

1. The Exchanger does not identify replacement property within the 45-day deadline;
2. After the identification period, when the Exchanger receives all identified property;
3. Upon the expiration of the 180-day exchange period;
4. After the identification period, upon the occurrence of a material and substantial contingency, provided for in writing, related to the exchange and beyond the control of the Exchanger (for example, a written contingency requiring a zoning change).

STORY: The Exchanger sells the apartment building that (unbeknownst to the exchange company) was their sole source of income. They need cash out of the exchange account to cover living expenses.

USE OF EXCHANGE FUNDS

Exchange funds may only be used to pay for:

1. Earnest money deposits for replacement property,
2. Replacement property, and
3. All typical and ordinary closing costs for *real estate* (including commissions).

Loan fees and appraisal fees are typical and ordinary closing costs for *financing* not for real estate.

Most attorneys would advise against using the funds for these expenses. The Exchanger should discuss any anticipated expenditures with their exchange company.

STORY: The client's broker tells them the exchange company can pay the attorney's fees, the CPA's bill and landscaping expenses for the relinquished property.

COOPERATION OF “THE OTHER PARTY” IS NOT REQUIRED

It is generally recommended that a cooperation clause be included in the purchase and sale agreement for the relinquished property. The language may be as simple as the following:

**Seller intends to complete a § 1031 tax-deferred exchange. Buyer
agrees to cooperate at no expense or delay to Buyer.**

In fact, Treasury Regulations only require that Buyer be **notified of the exchange** prior to closing. Their cooperation is not a requirement. If a Buyer balks at “cooperating” Seller can still proceed with the exchange. In this instance most exchange companies will prepare a “Notice of Exchange” for delivery to the Buyer.

It may be advisable to omit the cooperation clause from any offer for replacement property. If seller is aware that buyer is in an exchange, subject to stringent deadlines and identification rules, seller may take advantage of this information in any subsequent negotiations. Seller must be “notified” of the exchange prior to closing. The exchange documentation at the closing table will provide the required notice.

STORY: The Buyer on the Relinquished Property refused to sign the exchange document in an effort to obtain additional concessions from the Exchanger.

RELATED PARTIES

Swap with Related Party

STORY: Brother and Sister want to swap inherited interests.

Exchanges may take place between related parties. The only requirement is that **neither** may dispose of their replacement properties within two (2) years of the exchange. I.R.C. §1031(f).

Sale to Related Party

STORY: Mom and Dad sell land to Mom & Dad Development Company.

In a recent series of private letter rulings the IRS has allowed the Exchanger (using an Accommodator) to sell to a related party. The related party is under no obligation to hold the property for two years. See Priv Ltr Rul 200541037, 200706001, 2007090036, 200712013.

Purchase from Related Party

STORY: A corporation wants to buy property from a related corporation.

The 9th Circuit Court of Appeals in Teruya Brothers Ltd. V. Commissioner, 9th Cir. No. 05-73779 (Sept. 8, 2009) cert denied 2/22/2010 upheld a Tax Court decision disallowing an exchange where the replacement property was purchased from a related party. The 11th Circuit Court affirmed a similar ruling in Ocmulgee Fields, Inc., 132 T.C. 105(2009) *aff'd* (11th Cir. 8/13/2010) 106 AFTR 2d ¶2010-5198). The Malulani Group, Limited and Subsidiary v. Commissioner, T.C. Memo 2016-209 (11/16/16).

However, in numerous private letter rulings the Taxpayer has been allowed exchange treatment where it acquired replacement property from a related party as long as the related party is doing its own exchange.

DISSOLVING A PARTNERSHIP ON THE RELINQUISHED PROPERTY

STORY: Partnership of three is selling. Two want cash. The third wants an exchange.

Question - So, what's the problem?? **Answer** – The Taxpayer that sells the Relinquished Property must be the Taxpayer that acquires the Replacement Property.

The Partnership could certainly engage in an exchange with the sale of the real estate. However, the individual wanting an exchange has owned a partnership interest, not the real estate. The partners must consider a multitude of issues if they plan to dissolve the partnership and complete an exchange (aka “drop and swap”).

In a drop and swap, the partnership deeds to the individuals as tenants in common. Tax and legal advisors will have to work to perform beyond preparation and recording of the deed. Some “seasoning” of the tenancy-in-common is generally recommended before listing and selling the property.

The IRS may be looking at drop and swap exchanges. Two questions were added to the 2008 Form 1065 (Partnership Tax Return), presumably for the purpose of gathering data in order to issue future guidance.

Question 13 – Check this box if, during the current or prior tax year, the partnership distributed any property received in a like-kind exchange or contributed such property to another entity (including a disregarded entity).

Question 14 – At any time during the tax year, did the partnership distribute to any partner a tenancy-in-common or other undivided interest in partnership property?

Tax Preparer penalties have further curtailed the use of this strategy. A drop and swap is viewed as an aggressive tax strategy requiring disclosure.

SELLER FINANCING

STORY: The Exchanger sells free and clear relinquished property for \$100k. They receive cash of \$75k and a promissory note of \$25k.

It is always best for the Exchanger to have an all cash buyer for the relinquished property. Occasionally seller financing is necessary.

Options: If after consultation the Exchanger decides to accept a note, there are several options for handling the note:

Outside the Exchange

The note can pass directly to the Exchanger. The note will receive installment sale treatment. Capital gain is recognized as the principal is received. It is important to know that the note has a \$0 basis. The basis in the relinquished property will now be in the replacement property. Therefore, the entire note is taxable as gain.

Within the Exchange

The note and trust deed must be prepared showing the Accommodator as the beneficiary.

1. The Accommodator can **assign** the promissory note **to the Seller** of replacement property as part of the consideration for the purchase.

2. The Accommodator can **sell the note for cash** and use the cash to purchase replacement property. The Exchanger must consider whether the discount will exceed the capital gains tax they would otherwise pay on this note.
3. PLR 200241016 allowed the note to be sold to a **related party**. Usually the sale price is for full face value; no discounting.
4. If the Accommodator is unsuccessful in using the note it will be **assigned to the Exchanger** at the close of the exchange. The Exchanger will receive installment sale treatment as if the note had passed directly to them, outside the exchange.

Short-term Financing

Sometimes the Exchanger can negotiate a short-term note which will balloon within the exchange period. In order to use the note in the exchange it must be prepared with the Accommodator as the beneficiary. When the balloon is paid the Accommodator can use the funds to buy the replacement property.

Seller Financing on Replacement Property

There is no issue in the exchange if an Exchanger buys replacement property with financing from the seller of that property. Replacement debt can come from conventional or private sources.

REVERSE EXCHANGES

STORY: Due to limited available inventory the Exchanger wants purchase the replacement property, first, then list and sell theirs.

What is a Reverse Exchange?

A reverse exchange results when the Exchanger must buy replacement property before completing the sale of the relinquished property. While it is possible to do a reverse exchange what the Exchanger may not do is be the owner of both the relinquished and the replacement property at the same time. One of the properties must be owned (parked) with the Exchange Accommodation Titleholder (EAT), a service offered by most exchange companies.

Parking the Replacement Property (Exchange Last)

Most frequently the replacement property is parked with the EAT. The basic steps:

1. The exchange company forms a limited liability company (EAT) of which the exchange company is the sole member. It is permissible for the Exchanger to serve as the Manager.
2. The Exchanger delivers funds for the purchase to the closing.
3. The EAT gives the Exchanger a promissory note for equal amount.
4. The EAT leases the property to the Exchanger so that they have full control of the parked property including receiving and retaining any income.
5. When the relinquished property closes the exchange company uses the sale proceeds to redeem the note.

6. The exchange company then acquires the replacement property from the EAT and arranges for delivery of the property to the Exchanger by either deed or assignment of the membership interest in the LLC.

Parking the Relinquished Property (Exchange First)

This is a more difficult structure utilized most often when parking the replacement property with the EAT creates complications, for example, lender related issues (Fannie Mae, Freddy Mac, HUD, mezzanine financing). The basic steps:

1. The EAT and the Exchanger enter into a purchase and sale agreement with 100% financing to the Exchanger.
2. The sale is closed by deed transferring the relinquished property to the EAT.
3. The EAT leases the property to the Exchanger so that they have full control of the parked property including receiving and retaining any income.
4. With a simultaneous assignment of the promissory note, the exchange company uses that note to acquire the replacement property instructing the Seller to transfer the property directly to the Exchanger.
5. When the relinquished property is sold to the ultimate Buyer the sale proceeds are used to redeem the note.

Tax Reporting

The lease between the EAT and the Exchanger also facilitates tax reporting. The EAT must report on its federal return that it paid property tax and interest during the parking period. The EAT will

report lease income of an equivalent amount. The Exchanger cannot take those deductions on its tax return but will show the lease payment.

The challenges of a Reverse Exchange

1. Expense – extra closing costs, CPA time, lender fees, exchange fees, etc.
2. Hassle factor – double closings, liability insurance, lender issues, etc.
3. 180-day time frame.
4. Down payment – The Exchanger will have to provide the down payment for the replacement property and, ideally, this would approximate the equity in the relinquished property.
5. Set up time.

The alternatives

The best alternative is to negotiate with the seller to hold off closing on the replacement property until the relinquished property can be sold. The Exchanger may offer:

1. Additional earnest money
2. Non-refundable earnest money
3. Option Agreement
4. Rental Agreement
5. Lease/Option Agreement
6. Giving the Exchanger **possession** of the replacement property until the relinquished property closes **will not work**.

Non-Safe Harbor Reverse Exchanges

Estate of George H. Bartell Jr. et al. v. Commissioner, 147 TC 5 (June 10, 2016) upheld a reverse improvement exchange that extended over a period of 17 months. However, the IRS has issued an action on decision stating that reverse exchanges extending beyond the safe harbor timeframe will not qualify unless the EAT acquires the benefits and burdens of ownership. AOD 2017-06.

IMPROVEMENT EXCHANGES

STORY: Purchase a replacement property at a discount leaving room in the budget for renovations necessitated by Seller's deferred maintenance.

What is an Improvement Exchange?

The Exchanger has an Improvement (Build to Suit) Exchange if on the 45th day the replacement property does not exist or is under production.

Requirements

1. **Identification** - The regulations require "...as much detail...regarding construction of the improvements as is practicable at the time the identification is made." (Legal description + plans + specs)
2. **Production must take place before** the Exchanger receives the property. Any production after receipt of the property will be considered "goods and services," rather than "like-kind" real property, and will be taxable. In other words, the Exchanger cannot improve property they already own.

Structuring Options

1. The Exchanger can negotiate with the **Seller** of the replacement property to have the Seller make the improvements and increase the sales price.
2. The **Exchanger** can negotiate with the Seller of the replacement property to have allow the Exchanger to make the improvements prior to closing.
3. Have the **Accommodator** buy the property and make the improvements. The costs of this structure are essentially the same as for a reverse exchange.
4. The Exchanger can buy the property, receive the balance of the exchange account, **pay the tax** and improve the property with whatever cash remains.
5. A holdback in escrow does **not** work.

DESSERT

Personal Goals

1. **STORY:** Mom sells a rental house in Pullman to buy a rental house in St. Louis. (kid in college – must pay fair market rent)
2. **STORY:** Church member sells a four-plex to buy a commercial building to house his church. (Recommend that church pays rent.)
3. **STORY:** Client sells a duplex to buy a lot at Lake Chelan. (*Might* build own home 5 – 6 years later.)
4. **STORY:** Client is selling a house at the beach to buy a house in Phoenix. (Must be rentals.)
5. **STORY:** The Exchanger is selling a lot inherited in northern Wisconsin to buy a single level rental house in the local area.
6. **STORY:** The Exchangers are selling a single house to buy two houses – one in which her daughter will be the tenant and one in which his son will be the tenant.
7. **STORY:** Mom and Dad need to retire. The kids won't take over the family business (rental houses). Mom and Dad are selling the houses and buying fractional interests in commercial properties that they won't have to manage.
8. **STORY:** The former spouses are selling a co-owned commercial building and going their separate ways.
9. **STORY:** The Exchanger sells a commercial building to buy two replacement buildings – as equally valued as possible. Through his estate plan one will go to the son and the other to the daughter.

- 10. STORY:** The bed and breakfast operator is selling the bed and breakfast and buying bare land.
- 11. STORY:** The Exchanger is selling the old home place to a large corporation for \$2.0m. They don't want to sink all their proceeds back into real estate. (partial exchange)
- 12. STORY:** The Exchanger exchanged over a lifetime and passed the properties to his children. They children have owned the properties for a number of years and will do as Dad did, exchange, exchange, exchange.

Business Goals

- 13. STORY:** The Exchanger is selling a ranch in Nebraska to buy a ranch in Oregon. (relocating business)
- 14. STORY:** The Exchanger is retiring from Montana to Texas, selling the rentals in Montana to buy rentals in Texas.
- 15. STORY:** The Exchanger is selling two rentals to purchase a nut orchard.
- 16. STORY:** The Exchanger is getting out of motels and into gas station/convenience stores.
- 17. STORY:** The Exchanger sold a few years ago in California and bought in Washington. They are now selling the Washington property and are buying in Texas.
- 18. STORY:** The client is selling a cell tower easement off the side of their grain elevator to buy the land under the grain elevator from the railroad.
- 19. STORY:** The client is selling water rights in Utah and buying a rental house in Yakima.
- 20. STORY:** The Exchanger is selling a rental in a "partial" exchange where they are taking some cash out. The tax on the cash will be offset by carry forward losses.

Personal and Business Goals

21. **STORY:** The clients sell their own home where they have a rental unit.
22. **STORY:** The clients sell their own home where they run a business in the shop out back.
23. **STORY:** The clients sell their own home where they own a large parcel of land.
24. **STORY:** The clients sell a rental house to buy a chocolate shop.

BROKER/AGENT CHECKLIST

- 1. Spot the exchange opportunity.
- 2. Have client consult with their tax/legal advisor.
- 3. Have client call the exchange company.
- 4. Get client looking for replacement property.
- 5. Notify the exchange company when escrow is opened for relinquished property.
- 6. Notify the exchange company when escrow is opened for replacement property.
- 7. Know that there are limitations on use of the exchange funds.
- 8. Know that there are rigid restrictions on returning exchange funds to the client.
- 9. Call the exchange company with any questions but always with the following:
 - Buying from a related party.
 - Different ownership on the relinquished property and replacement property.
 - Seller financing on relinquished property.
 - Client wants to make improvements on replacement property.
 - Client wants to buy before selling.

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