

1031 EXCHANGES

Real Property Applications

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§1031 Websites

www.irs.gov - I.R.S. homepage

- Tax Forms and Publications
- Publication 544 - Sales and Other Dispositions of Assets
- Disaster Relief Extensions

www.ipx1031.com - Investment Property Exchange Services (IPX1031)

- Bookmark and label “1031 Information”
- “Exchange Topics”
- Monthly and On-Demand Webinars – Basic and Advanced
- Time Calculator & Cap Gains Examples

Internal Revenue Code §1031

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

Gain is not realized until an investor “cashes out” of the investment

Like-Kind Requirement

In a 1031 Exchange the property that is sold and purchased must be held for investment purposes or for the productive use in a business or trade.

- Single Family Rentals
- Townhome & Condo Rentals
- Plexes (duplex, triplex, etc.)
- Vacant Land
- Multi-Family
- Industrial
- Office
- Retail
- Hospitality
- Senior Housing
- Fractional Ownership (TIC or DST)
- Cell Towers
- Billboards
- Windmills
- Solar Farms
- Air Rights & Water Rights
- Oil, Gas & Mineral Rights
- Boat Docks
- Moorings
- Cemetery Plots

Excluded Property

Never like kind under §1031

1. Property held primarily for sale
 - Inventory
2. Personal Property (as of Jan. 2018)
3. Stocks, bonds or notes
4. Securities or other evidence of indebtedness
5. Interests in a Partnership
6. Primary residence and second homes
7. Foreign property for U.S. property or vice versa

EXCHANGE MOTIVES

Cashflow

Sell vacant land; acquire improved property to generate cash flow.

Depreciation

Exchange from fully depreciated property to a higher value property – the additional value can be depreciated.

Appreciation

Dispose of property in a slow market area and acquire property in a hot market area.

Conversion

Acquire property suitable for future conversion to primary residence or vacation home.

Consolidate/Diversify

Reduce Management Burdens

Acquire management-free property.

Estate Planning

Dispose of one property and acquire several properties (example: distribute one replacement property to each family member).

Use in Profession

For example, a doctor sells a rental house and acquires a medical building to support the practice.



What Taxes Am I Able to Defer?

Federal Capital Gains Tax

Either 15% or 20% of the gain, depending on Taxable Income
- 20% if T.I. is above \$441,451 if single, \$496,601 if married filing jointly

State Ordinary Income Tax

Depends on tax bracket, but in CA usually 9.3% to 13.3%

Net Investment Income Tax (Healthcare Tax)

3.8% if AGI is above \$200K single or \$250K married filing jointly

Depreciation Recapture

25% of depreciation taken

BASIC 1031 RULES

In order to obtain a deferral of the entire capital gain tax the Exchanger must:

1

EQUAL OR GREATER

Purchase property of **EQUAL OR GREATER** value.

2

REINVEST

Reinvest **ALL of the net proceeds** from the relinquished property.

3

REPLACE THE VALUE OF THE DEBT

Replace the value of the debt that was on the relinquished property. This can be achieved by placing a loan on the replacement property of an equal amount, injecting equity from outside of the exchange into the replacement property or a combination of these.

To the extent the Exchanger fails to observe these rules they will be subject to capital gain tax on what is not reinvested.

California “Clawback”

Assembly Bill 92 passed in June 2013

- Added Sections 18032 & 24953 to CA Tax & Revenue Code
- If you sell CA property and Exchange out of State, you will be required to file an informational tax return each year with the State of California
- Once you “cash out” **OR** fail to file the informational tax return, the CA FTB can assess taxes and claw them back
- Effective for Exchanges where the sale occurred **AFTER** January 1, 2014

Essential Knowledge

Q: When does a 1031 exchange need to be set up?

A: **Before** the Relinquished Property is transferred.

- The QI must assign into the contract. Otherwise there is a taxable sale.

Timelines

In a *Delayed Exchange*, the clock starts ticking on the Exchange once the Relinquished Property transfers ownership from the Seller to the Buyer. From that date you have:

- 45 Calendar Days to Identify Replacement Property(ies)
- 180 Calendar Days to Close on one or more of the Identified Properties
 - Weekends & holidays do **not** push the dates to the next business day.

Identification Rules

The IRS Outlines That You Have 3 Options

- **3 Property Rule**
Identify up to 3 properties without regard to value
- **200% Rule**
Identify 4 or more properties, the total value of all cannot exceed 200% of the value of the property sold
- **95% Rule**
Must purchase 95% of the value of all properties identified

***There are only **TWO** instances where the ID Period or Exchange Period can be extended: Military Deployment or a Federal Disaster Relief Extension issued by the IRS.

History of Disaster Extensions for 1031 Exchanges

- **May 2005:** IRS issues Revenue Procedure 2005-27 which for the first time specifically mentions extensions for 1031 exchange taxpayers affected by federally declared disasters, under Section 17.
- **September 2005:** The first notable disaster relief for 1031 exchanges occurs due to the devastation of Hurricanes Katrina & Rita in the Southeastern United States. Relief is granted to taxpayers in the affected areas.
- **2007:** The IRS issues Revenue Procedure 2007-56, which replaces Rev. Proc. 2005-27. This Revenue Procedure provides more specific authority to the IRS Commissioner to extend certain 1031 timelines and explicitly defines “affected taxpayer”.
- **2018:** Rev. Proc. 2018-58 formally replaces Rev. Proc. 2007-56 and provides the most current look at “Disaster Relief Extensions”

Revenue Procedure 2018-58

Rev. Proc. 2018-58 provides postponements of the 45 and 180 day periods for federally declared disasters

- For 120 days or to the last day of the extension period authorized by the IRS (whichever is later)
- After the event, the IRS will release a “Disaster Relief Notice”
 - Identifies counties (state by state) which have been declared disaster areas
 - Other counties may be added to list on IRS website
 - Must reference Rev. Proc. 2018-58 for the extension to apply to 1031 deadlines

IRS Notice 2020-23

Extensions to §1031 Deadlines

Closed Escrow on Relinquish Property	Old 45th ID Date	New 45th ID Date	Old 180th Day	New 180th Day
October 4, 2019 to January 17, 2020	November 18, 2019 to March 2, 2020	NO CHANGE	April 1, 2020 to July 14, 2020	July 15, 2020
January 18, 2020 to February 15, 2020	March 3, 2020 to March 31, 2020	NO CHANGE	July 16, 2020 to August 13, 2020	NO CHANGE
February 16, 2020 to May 31, 2020	April 1, 2020 to July 15, 2020	July 15 2020	August 14, 2020 +	NO CHANGE

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Reverse Exchanges

- Opposite of a forward exchange
- Exchanger wants to acquire Replacement Property first and sell Relinquished Property later
- When to use
 - Relinquished Property falls out of escrow
 - Exchanger finds Replacement Property and is ready to close before

Delayed Improvement Exchanges (Build-To-Suit)

When to use

- Purchase price of Replacement Property is less than net sales price of Relinquished Property **and**
- Exchanger intends to improve Replacement Property with excess exchange funds

Identifying the Exchanger (Vesting of Title Issues)

General Rule – Title to Replacement Property must be held in the same manner as title to the Relinquished Property

Focuses on the person/entity “in title”

To be an exchange:

- If ABC Corp sells ABC Corp must acquire
- If ABC Corp sells and XYZ Corp acquires it is a transfer **not** an exchange

Partnership Issues

A Partnership can complete an Exchange

- However, §1031(a)(2)(D) prevents a partner from exchanging its interest in a Partnership

An interest in a Partnership is **NEVER** Like Kind

5 Techniques to Resolve Partnership Issues

1. Drop & Swap
2. Purchase interest of retiring partner
3. Partnership sells Relinquished property for cash and an Installment Note
4. Distribute an undivided interest in Partnership property
5. Partnership Division

Appeal of Sharon Mitchell

- CA drop and swap case – TP won
 - Drop occurred two days prior to closing and after the PSA was signed
- The FTB petitioned for a rehearing
- OTA denied the request on January 28, 2020
- Copies of both decisions are attached to the webinar

Effect

- This was not an appeal
 - The 1/28/2020 decision denied the FTB's request for a rehearing (the appeal was the initial OTA decision on 8/2/18)
 - The Court held that none of the grounds needed for a rehearing were present and denied the FTB's request
 - The case is not precedential
 - It cannot be relied upon as authority in future audits or litigation
 - It is not clear that the FTB will change its position on Drops & Swaps
 - Based on informal communications with the FTB, this is not likely
 - TPs need to be prepared to litigate
 - The decision only relates to CA state tax
 - Not Federal or any other state

Implication of Decision

- Probably the greatest impact is on tax advisors, not us
 - Although they cannot rely on the decision (unless it is made precedential) they could try to structure future arguments based on the OTA's decisions
 - Drop & Swap transactions remain risky and TPs **MUST** seek the counsel of their tax advisors

Can 1031s be combined with an OZ?

- Maybe
 - Structure - start a 1031 and during the ID period decide whether they want to continue with the 1031 or invest in an OZ fund
 - If decide on OZ fund, **MUST** have 1031 fail in 45 days (not ID any property or revoke any IDs prior to day 45)
 - Revocations must be made to whoever the original ID was made!
 - Then receive proceeds on day 46 and have the balance of 180 days to invest into an OZ fund
 - If fail to revoke then cannot invest in OZ fund
 - Get \$ on day 181 (at the earliest)

Comparison Matrix

	<u>1031</u>	<u>OZ Fund</u>
Tax Deferral	Yes	Until 12/31/26 or sale of Fund (whichever is first)
1031 on sale of investment	Yes	No, at least 85% of Cap. Gain will be taxable on or before 12/31/2026
Invest. Req.	Net sales Price	Capital Gain
Min. Hold	Satisfy “Held For” Req.	5 or 7 years to receive a reduction of taxes

Comparison Matrix

	<u>1031</u>	<u>OZ Fund</u>
Investment Property	Real estate	Security
Secondary Market	Yes	?
Eligibility to invest	Anybody	Generally Accredited Investors

What is an Accredited Investor?

- Individual
 - Net Worth of \$1MM (excluding home)
 - AGI of \$200K for the past two years (\$300K for joint income)
 - With expectation that it will continue
- Entity
 - \$5MM of assets

Who Can be the Qualified Intermediary?

According to the IRS, “Qualified” means

- That you are **NOT** Disqualified
- Who is Disqualified?
 1. The Exchanger
 2. A related party of the Exchanger
 3. An agent of the Exchanger

Agent is defined as an ex-employee, attorney, accountant, investment banker or broker or a real estate agent or broker within the last two years

- Everyone else is “**Qualified**”

Who Can be the Qualified Intermediary?



Rocco wants your money!!

Industry Nightmares

Southwest Exchange

- Exchange Funds Used to Launch Side Business That Failed (Losses of \$98M)
- Owner sentenced to 10 years in Federal Prison
- Lawsuits Helped Recover Approximately 90%

The 1031 Tax Group (as seen on American Greed)

- Funds Used to Pad Lavish Lifestyle (Real Estate Developments, Yachts, etc.)
- Owner, Ed Okun, sentenced to 100 years in Federal Prison as a Result

LandAmerica Exchange

- Approximately \$300M of Exchange Funds Tied Up in Auction Rate Securities
- Parent Company (LFG) Didn't Have Cash Reserves to Back Them Out & Filed for BK
- Most Exchangers Waited in Line Behind Creditors and Got Pennies on the Dollar

Summit 1031

- Closed as a Result of Liquidity Crisis Due to Loans Made, Using Exchange Funds, to a Subsidiary Company

What to Look For in a QI

Security of Funds

- Third Party Performance Guarantee
- A significant Fidelity Bond
- Errors & Omissions Insurance
- Where are the \$ invested and are they safe?

Are they secure and will they continue to be around?

- Entities vs. Individuals

Financial Strength and Sound Business Practices

- What are their accounting practices
 - 3rd party audits
 - Dual signatures on disbursements
 - Written authorization of exchanger to disburse exchange funds

Compliance with IRS Regulations

- Need to comply to be within “safe harbors”

Trained and certified employees

Qualified Trust Accounts – Additional Security

Due to the market imbalance, many of our clients are asking for an additional layer of security to protect their assets in the event of a failure of the QI. A Qualified Trust Account does the following:

- Trust accounts remain separate and cannot be attached by creditors in a bankruptcy action
- QT accounts require an extra set of eyes on any disbursement: the Exchange Officer, the segregated Banking Officer ***and*** the trustee.
- QT's give clients a measure of relief because their funds are being held in specific ***trust*** accounts at the nation's strongest banks.
 - At IPX, we are only using CitiBank for QT accounts.
 - By Feb 2009 the Fed acquired as much as 36% to prop it up. Too big to fail?

Question to Think About

What did they successfully prosecute Al Capone for?

- The motto of the Criminal Investigation division of the IRS is ***If the FBI can't catch you, the accountants with guns will!***

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