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CELEBRATING OUR 30th ANNIVERSARY

IRC §1031

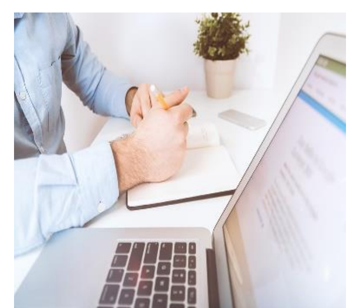
Tax-Deferred Exchanges

Presented By:

Mary Cunningham, President & CEO

Teresa Fluegel, Executive Vice President

www.cdec1031.com



What You Will Learn:

- Recent Developments in IRC Section 1031
- Forward Exchange Mechanics and the Role of the QI
- Reverse Exchange Mechanics and Improvement Exchanges
- Critical Timelines and Boot Netting Rules
- Partnership Issues and other FAQs

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Potential Legislative Modifications

The Biden Administration's Fiscal Year 2022 Budget, proposed to cap the gain deferral available under IRC Section 1031 to $500,000 per taxpayer, or $1 million for married couples filing jointly.

On September 13, 2021, the House Ways & Means Committee released several markups of proposed legislation intended to be pay-fors for various spending initiatives. The mark-ups did not include any modifications to IRC Section 1031.

The Build Back Better legislation, that is now stalled (or dead) in the Senate, did not contain any modifications or limitations on IRC Section 1031.

Nevertheless we will continue to stay in touch with policy makers to monitor activity throughout the remainder of the legislative term.

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Potential Legislative Modifications

The Federation of Exchange Accommodators (the national trade association for Qualified Intermediaries) has co-sponsoring two economic studies:

1. Ernst & Young macroeconomic study examines the economic impact of repealing IRC Section 1031; and

2. The Ling-Petrova academic microeconomic study examines tens of thousands of commercial real estate transactions conducted between 2015 and 2019 and describe the potential ramifications to transaction activity if Section 1031 is repealed.

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Legislative Issues

What Can You Do?

1. Visit www.1031buildsamerica.org and let your elected representatives know that IRC Section 1031 should not be repealed or restricted.

2. Share your positive experience with the Federation of Exchange Accommodators at www.1031.org

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The Tax Cuts and Jobs Act of 2017

On December 22, 2017 President Trump signed into law the Tax Cuts & Jobs Act of 2017 (TCJA).

The TCJA limits tax-deferral under IRC Section 1031 to real property that is not held primarily for sale.

Exchanges of personal property, capital assets, intangibles & collectibles are no longer permitted.

The modification applies to exchanges completed after December 31, 2017.

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What does Section 1031 say? Effective January 1, 2018:

IRC Section 1031(a)(1): No gain or loss shall be recognized on the exchange of **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 either for productive use in a trade or business or for investment.

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Non-Qualifying Real Property

Any real property held primarily for sale.

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Benefits of a Section 1031 Exchange

1. Tax Deferral
   - 20% Federal Capital Gain Tax for assets held > 1 year
   - 25% Federal Depreciation Recapture Tax
   - 13.8% California State Income Taxes (if applicable)
   - 3.8% Medicare Tax on net investment income
2. Diversification of Real Estate Portfolio
3. Consolidation
4. Increased Cash Flow
5. Increased Appreciation
6. Pride of Ownership
7. Better Location
8. Estate Planning

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The Cost of Not Exchanging

Facts:

$1,000,000 purchase price

$100,000 depreciation

$50,000 capital improvements

$2,000,000 sales price

Adjusted Basis

Purchase Price	$1,000,000
(Depreciation)	$100,000
+ Capital Improvements	$50,000
Adjusted Basis	$950,000

The Cost of Not Exchanging

Gain Calculation:

Sale Price:	$2,000,000
Adjusted Basis:	($950,000)
Realized Gain:	$1,050,000

Taxes:

Depreciation Recapture: $100,000 x 25% = $ 25,000

Federal Capital Gains Tax: $1,050,000 x 20% = $210,000

California State Income Tax*: $1,050,000 x 13.3% = $139,650

Net Investment Income Tax: $800,000 x 3.8% = $30,400

Total taxes due: $402,350

*Assumes top income tax rate

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Starker and The 1984 Tax Reform Act

In the mid-1970s, the **Starker** cases set the stage for the non-simultaneous exchange.

In 1984, the **Tax Reform Act** formally sanctioned the delay between the disposition of relinquished property and the acquisition of replacement property.

The 1984 Tax Reform Act also imposed the **45-day Identification Period** and the **180-day Exchange Period.**

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The Role of the Qualified Intermediary

A Qualified Intermediary is an unrelated third party who is not the Taxpayer or a Disqualified Person who acts to facilitate a deferred exchange on behalf of the taxpayer under IRC Section 1031.

The QI must be involved **prior to** the close of escrow in order to provide exchange documentation so that there is no constructive or actual receipt of funds at closing.

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The Role of the Qualified Intermediary

Chicago Deferred Exchange Company ("CDEC") is one of the nation's oldest and largest providers of Qualified Intermediary and Exchange Accommodation Titleholder services for investors looking to structure tax-deferred exchanges under IRC Section 1031.

CDEC is a subsidiary of Wintrust Financial Corporation, a $50 billion financial services company.

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IRC Section 1031 General Statutory Requirements

Properties Must be Held for **Business or Investment Use.**

The Relinquished Property and the Replacement Property Must Be **Like-Kind** to Each Other.

The Transaction Must be Structured as an **Exchange** of One Property for Another as Distinguished from a Sale Followed by a Purchase.

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Business or Investment Use Property

Property must be held for **investment** or for **use in a trade or business** in which 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.**

Business or Investment Use Property

Example:

Taxpayer sells relinquished property in August and enters into a tax-deferred exchange.

Taxpayer acquires replacement property in November.

In January, Taxpayer receives and accepts an offer to **sell** his newly acquired replacement property to the owner of adjacent property.

Can Taxpayer structure the transaction as an exchange?

Has Taxpayer held the replacement property for the requisite intent?

Business or Investment Use Property

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.

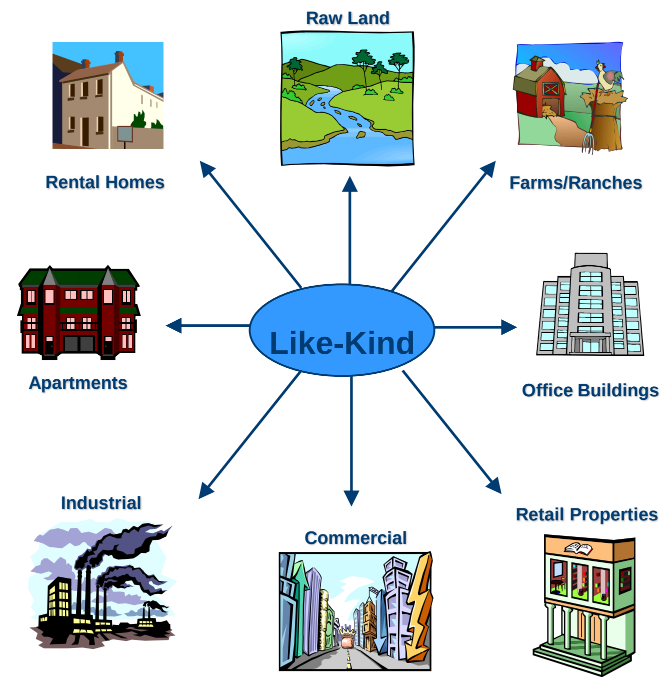
The exchange was disallowed and Taxpayer was deemed to have held the lots primarily "for sale".

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."

Like-Kind Standard – United States

Real Property Interests that are Like-Kind

- Multi-Family Property
- Single Family Rental
- Shopping Center/Strip Center
- Vacant Land
- Tenancy in Common Interest
- Industrial Property
- Retail Property
- Office Property
- Timberland
- Single Tenant or Triple Net Leased Property
- Beneficial Interest in a Delaware Statutory Trust
- Existing Leasehold Interest with 30 years or more to run



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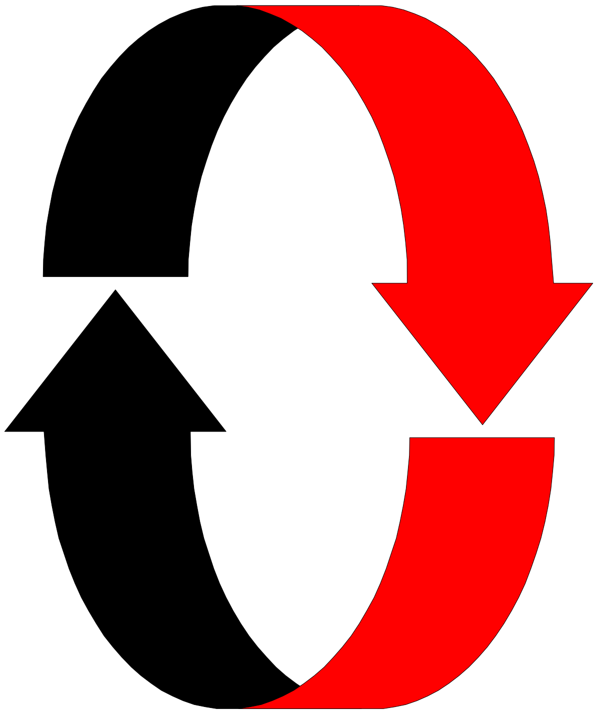
Exchange Requirement

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.

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Exchange Requirement – Constructive Receipt

Crandall & Dulin v. Commissioner T.C. Summary Opinion, 2011-14

Taxpayers had constructive receipt of the sale proceeds from the moment their relinquished property was transferred.

The exchange was disallowed.

Exchange Requirement – Actual Receipt

Morton v. U.S., 107 AFTR 2d 2011

Taxpayer sues for refund of taxes paid on a like-kind exchange of aircraft.

Tax-deferral was denied because the Taxpayer had actual receipt of the cash from the sale.

The escrow company assisting with the transactions mistakenly wired sale proceeds to the Taxpayer's account.

The error was rectified and Taxpayer prevailed in arguing that it was clear his intention was to exchange the aircraft.

Structuring a Forward Exchange – Documents

Prior to Closing on the Sale of Relinquished Property, Taxpayer executes:

1. An Exchange Agreement with a QI;

2. A Trust Agreement/Escrow Agreement/Bank Account Agreement with a trustee/escrowee/depository institution;

3. An assignment of Taxpayer's rights under the Purchase and Sale Agreement to the QI.

Structuring a Forward Exchange – the QI "Acquires and Transfers" the Relinquished Property

The QI is tasked with acquiring and transferring the relinquished property from the Taxpayer to the third party Purchaser.

The Taxpayer assigns its rights under the PSA to the QI and provides notice of the assignment, in writing, to the other parties to the agreement.

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Structuring a Forward Exchange – the QI "Acquires and Transfers" the Relinquished Property

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.

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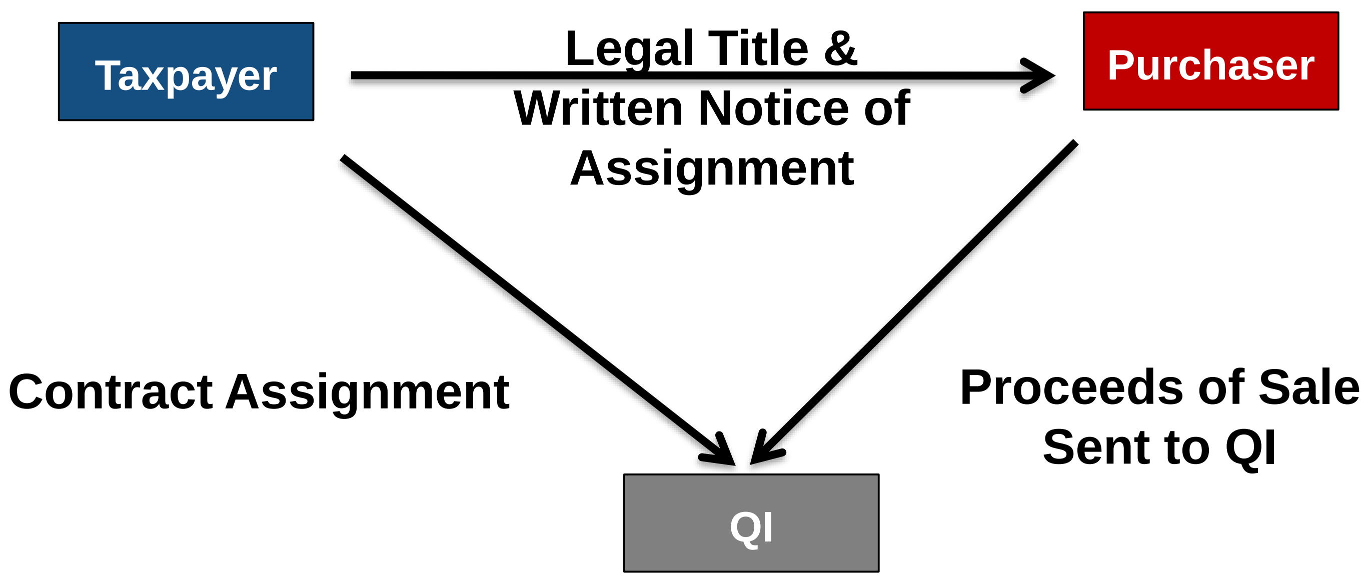
Structuring a Forward Exchange – Proceeds of Sale Sent to QI

Transfer of Relinquished Property



Structuring a Forward Exchange – Proceeds of Sale Held by QI

Relinquished Property sale proceeds must be held in a "**qualified account**" in order for the Taxpayer to avoid being in constructive receipt of the proceeds.

The account is a "qualified" account if the Taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of the cash are limited to those specific exceptions described in the Treasury Regulations.

These restrictions pursuant to which the funds are held are colloquially referred to as the **"(g)(6)"** restrictions.

Structuring a Forward Exchange – Proceeds of Sale Held by QI – (g)(6)

Taxpayer may not have the right to receive, pledge, borrow, or otherwise obtain the benefits of the cash until:

The end of the Exchange Period; or

After the end of the Identification Period if no replacement property is identified; or

After the Taxpayer has received all of the identified replacement property to which it is entitled.

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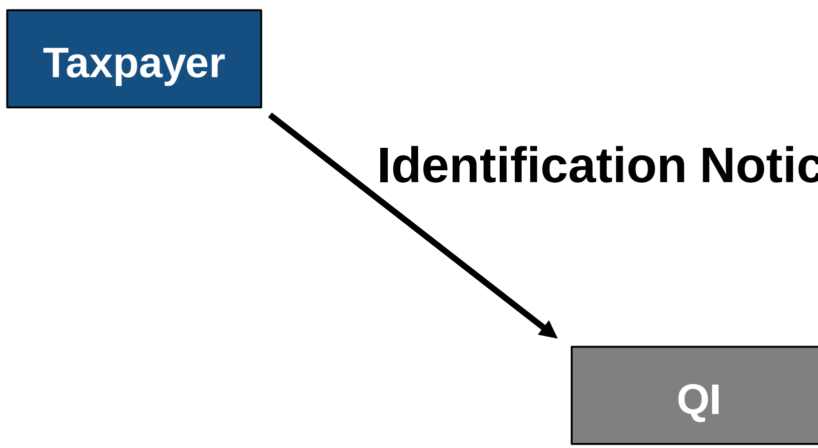
Structuring a Forward Exchange – Identifying Replacement Property

The Identification Notice must be made in a written document that is signed by the Taxpayer and hand delivered, mailed, telecopied or otherwise sent before the end of the Identification Period.



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Identification of Replacement Property

Three-Property Rule
Up to three properties of any FMV.

OR

200% Rule
Any number of properties provided the aggregate FMV of all of the properties doesn't exceed 200% of the FMV of the relinquished property.

OR

95% Rule
Acquire 95% of FMV of all Identified Properties

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Structuring a Forward Exchange – Identifying Replacement Property

- 231 S. LaSalle Street, Chicago, IL

  Property may be described by street address, city & state.

- The Empire State Building

  Property may be described by "distinguishable name"

- NE corner of Hollywood & Vine Streets, Hollywood, CA

  Property must be "unambiguously described".

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Structuring a Forward Exchange – Identifying Replacement Property

Dobrich v. Commissioner, T.C. Memo 1997-477

Taxpayer husband & wife sold investment property in California. They acquired three replacement properties that were not identified to their Qualified Intermediary.

The transaction preceded the issuance of the Treasury Regulations and the formal guidance re: identification requirements.

Taxpayer claimed he identified the properties verbally to his wife.

Structuring a Forward Exchange – Identifying Replacement Property

Dobrich v. Commissioner, T.C. Memo 1997-477

At trial it was revealed that Mr. Dobrich asked his real estate broker to back-date offers on the replacement properties so they fell within the 45-day window.

None of the properties were listed for sale during the 45-day window.

The Tax Court found clear and convincing evidence of intent to commit criminal tax fraud.

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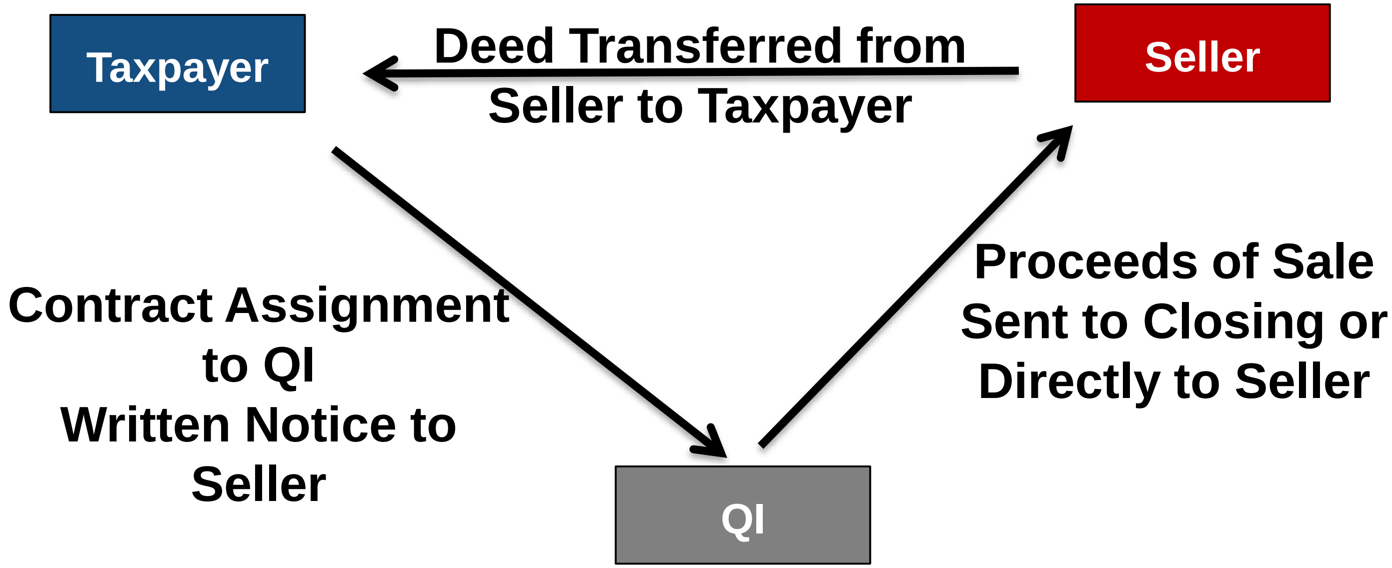
Structuring a Forward Exchange – Acquiring Replacement Property

Acquisition of Replacement Property



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Maximizing Tax Deferral - Avoiding Boot

What is “Boot”?

Boot is other property or money received in the exchange that is not like kind to the property given up and causes gain recognition.

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Maximizing Tax Deferral - Avoiding Boot

Boot Netting Rules

The rules regarding the effect of receiving boot are found at Treasury Regulation 1.1031(b)-1.

General Rules to Maximize Deferral

1. Acquire replacement property of equal or greater value than the relinquished property;

and

2. Reinvest all equity into replacement property

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Maximizing Tax Deferral - Avoiding Boot

Examples: Cash paid offsets cash received.

Relinquished Property		Replacement Property	
FMV:	$100	FMV:	$100
Debt:	$ 0	Debt:	$ 0
Equity:	$100	Equity:	$100

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Maximizing Tax Deferral - Avoiding Boot

Examples: Cash paid offsets debt relief.

Relinquished Property	
FMV:	$100
Debt:	$ 50
Equity:	$ 50

Replacement Property	
FMV:	$100
Debt:	$ 0
Equity:	$100

When Relinquished Property is sold, Taxpayer is relieved of $50 of debt.

Relief of debt will cause gain recognition if the debt is not otherwise offset with cash or new debt.

Maximizing Tax Deferral - Avoiding Boot

Examples: Debt assumed (or new debt) offsets debt relief.

Relinquished Property		Replacement Property	
FMV:	$100	FMV:	$100
Debt:	$ 50	Debt:	$ 50
Equity:	$ 50	Equity:	$ 50

New debt on replacement property offsets debt relief from the sale of the relinquished property.

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Maximizing Tax Deferral - Avoiding Boot

Examples: Debt assumed (or new debt) does <u>not</u> offset cash received.

Relinquished Property		Replacement Property	
FMV:	**$100**	**FMV:**	**$100**
Debt:	**$ 50**	**Debt:**	**$ 70**
Equity:	**$ 50**	**Equity:**	**$ 30**

Excess debt on replacement property results in Taxpayer having unexpended cash.

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Maximizing Tax Deferral - Avoiding Boot

Dealing with Excess Debt and Unspent Equity

Taxpayer can spend all of the equity on replacement property and re-finance the replacement property after closing.

How long after closing should the re-finance occur?

Taxpayer should consider the new limitation on deductions for business interest expense.

Exchanges Involving Partnerships

IRC Section 1031(e): Applications to Certain Partnerships

Exchanges of partnership interests are non-qualifying property for purposes of IRC Section 1031.

Tenancy in common interests can be exchanged for fee interests in real estate.

Exchanges can be accomplished at the partnership level, provided that the taxpaying entity remains the same.

What do you do when partners want to separate?

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Exchanges Involving Partnerships

Drop and Swap

Dissolve the partnership and distribute tenancy in common interests prior to closing.

The partners can then choose to sell or exchange their interests.

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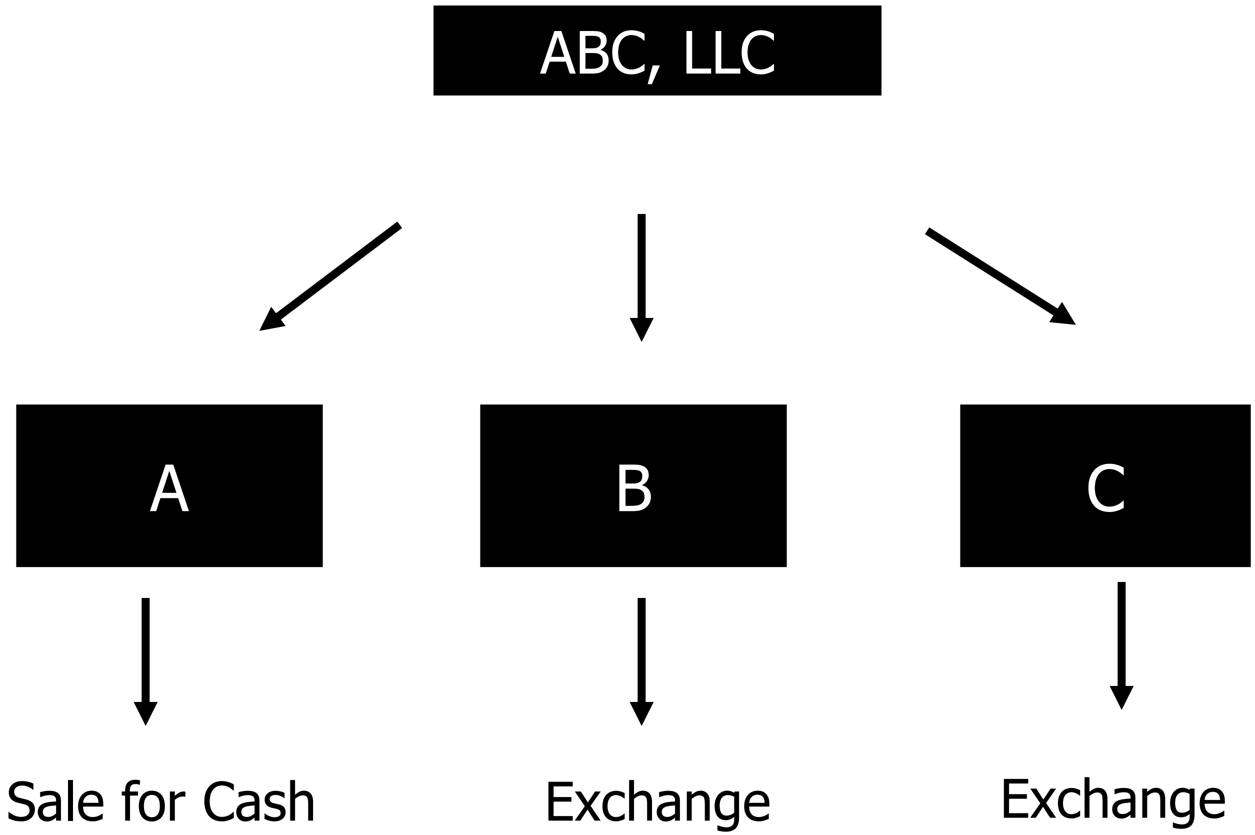
Dissolving the Partnership: "Drop & Swap"



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Dissolving the Partnership: "Drop & Swap"

Transfer from partnership to individual co-owners should be done in advance of closing.

The partners should act as co-tenants.

- Contrast *Chase v. Commissioner* where taxpayer received an undivided 46% interest in property previously held by partnership.
- The deed from partnership to Chase was never recorded, all income and expenses were paid into the partnership account.

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Dissolving the Partnership: “Drop & Swap”

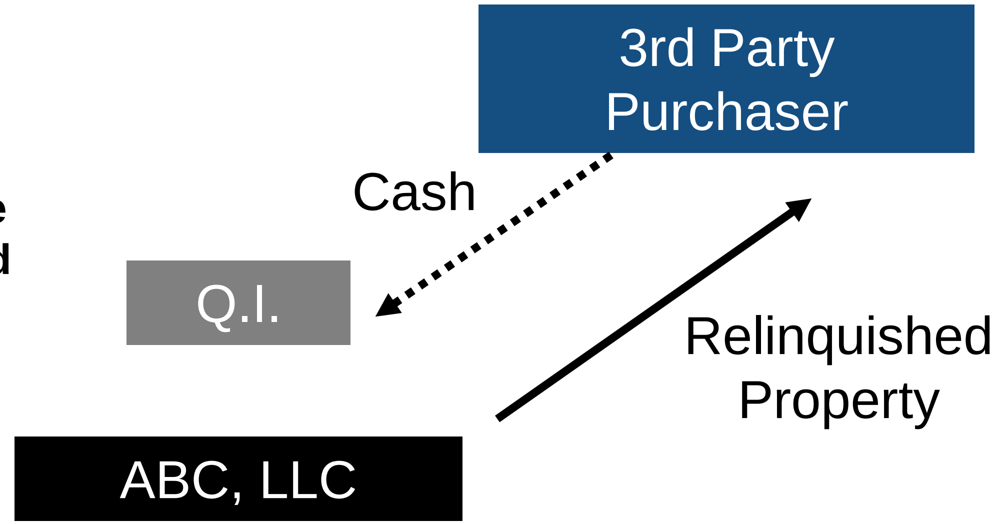
Rev. Ruling 75-292 and Rev. Rul 77-337:

The IRS ruled the “held for” requirement under Section 1031 could not be attributed to another entity through a non-recognition transaction.

The IRS has argued, and lost, the “held for” issue in several cases including: *Magneson*, *Bolker* and *Maloney*.

Post-Exchange Partnership Dissolution: “Swap and Drop”

ABC, LLC sells relinquished property to Purchaser: funds are directed to the Qualified Intermediary



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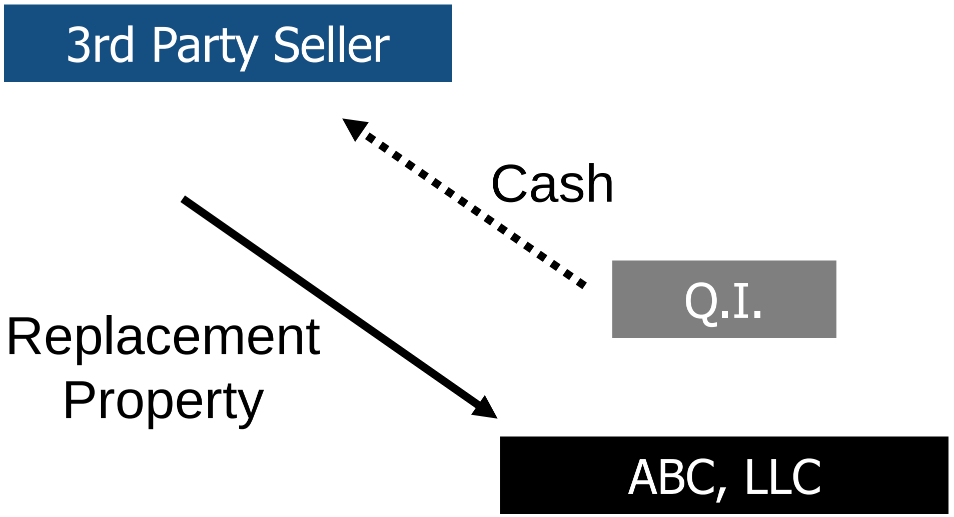
Post-Exchange Partnership Dissolution: "Swap and Drop"



ABC, LLC acquires replacement property from Seller: funds are wired from the Qualified Intermediary

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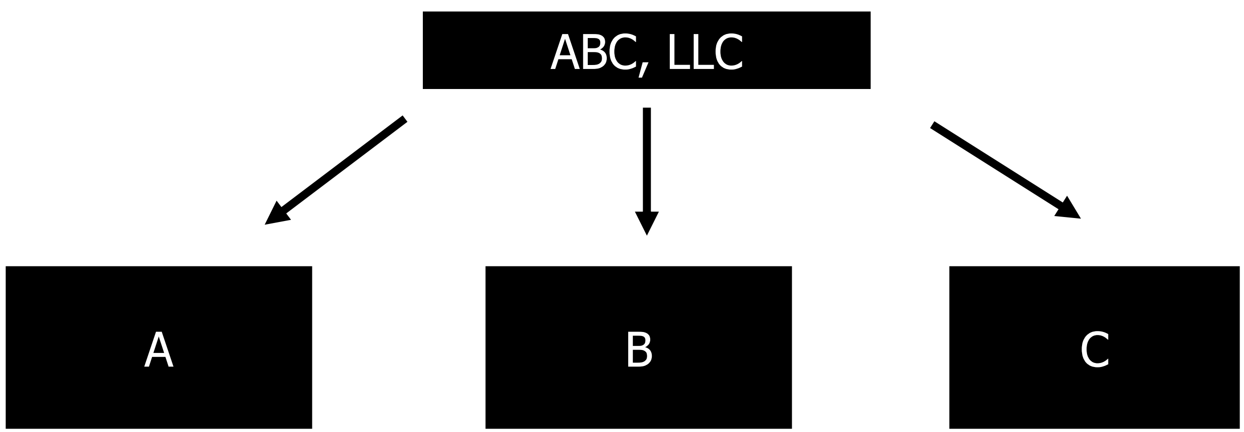
Post-Exchange Partnership Dissolution: "Swap and Drop"

At some date after closing, ABC, LLC distributes tenancy in common interests in the property to the individual partners.



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Post-Exchange Partnership Dissolution: “Swap and Drop”

In *Maloney v. Commissioner,* Taxpayer corporation acquired replacement property then immediately liquidated and distributed property to the shareholders.

The Service argued that Maloney did not continue to hold the property for investment.

The Tax Court held that the dissolution was a continuation of an economic interest in the same investment.

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Partial Installment Sale

At the relinquished property closing, ABC, LLC takes a note from the purchaser payable to the partnership.

In redemption of C’s interest, the partnership endorses the note to C.

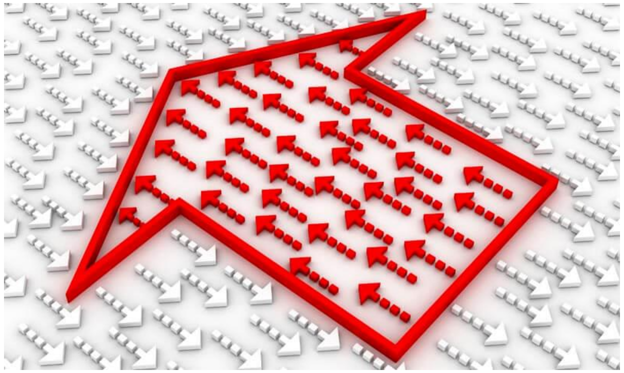
Partnership acquires replacement property without C.

Reverse Exchanges

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.”



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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.

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Parking Arrangement Conditions

Indicia of Ownership must be transferred to the "Exchange Accommodation Titleholder" (EAT).

EAT can acquire either the Relinquished Property (exchange first) or the Replacement Property (exchange last).

All parties must treat the EAT as the beneficial owner of the parked property for federal income tax purposes.

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Parking Arrangement Conditions

Taxpayer must identify the Relinquished Property within **45 days** from the date the EAT acquires the parked replacement property.

Combined period the property is held in the parking arrangement cannot exceed **180 days**.

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Permissible Agreements

EAT can also act as QI.

Taxpayer can guarantee or co-sign on any loan documents or debt instruments the EAT takes on to acquire the parked property.

Taxpayer can loan funds directly to the EAT at no interest.

Permissible Agreements

EAT can lease the parked property to the Taxpayer at no rent.

Taxpayer can manage the property, and oversee construction of improvements on the property.

The Accommodation Agreement can include put and call provisions as well as formula pricing to account for any gain or loss that occurs while the EAT owns the property.

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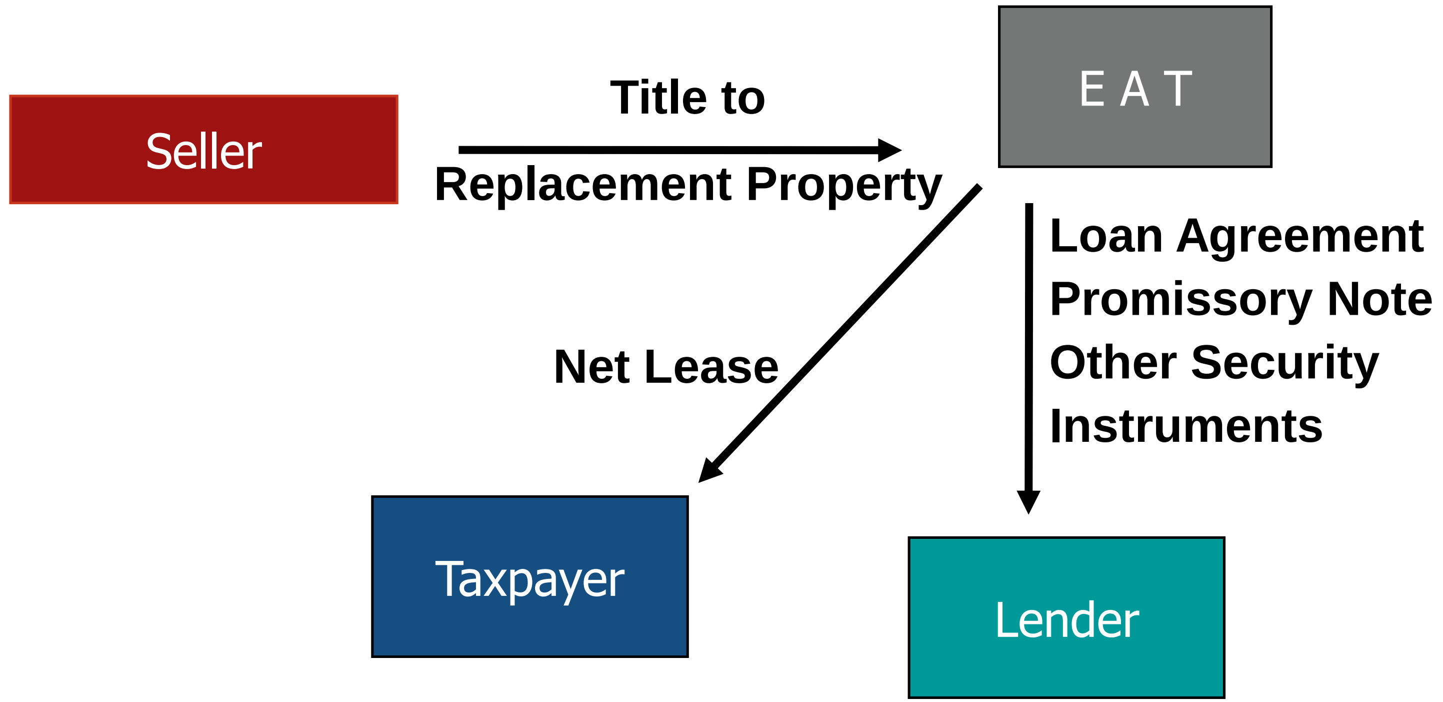
Replacement Property Parking

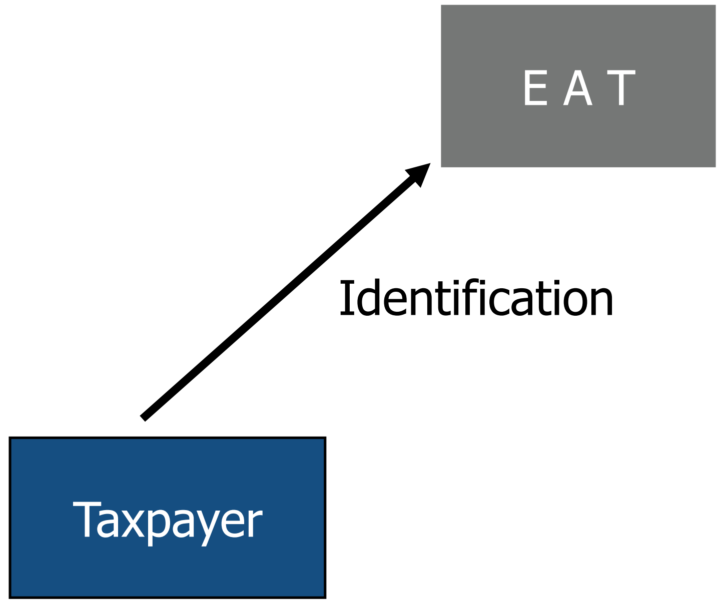
Acquisition of Replacement Property by EAT



Replacement Property Parking

Identification of Relinquished Property

The Identification Notice must be made in a written document that is signed by the Taxpayer and hand delivered, mailed, telecopied or otherwise sent before the end of the Identification Period.



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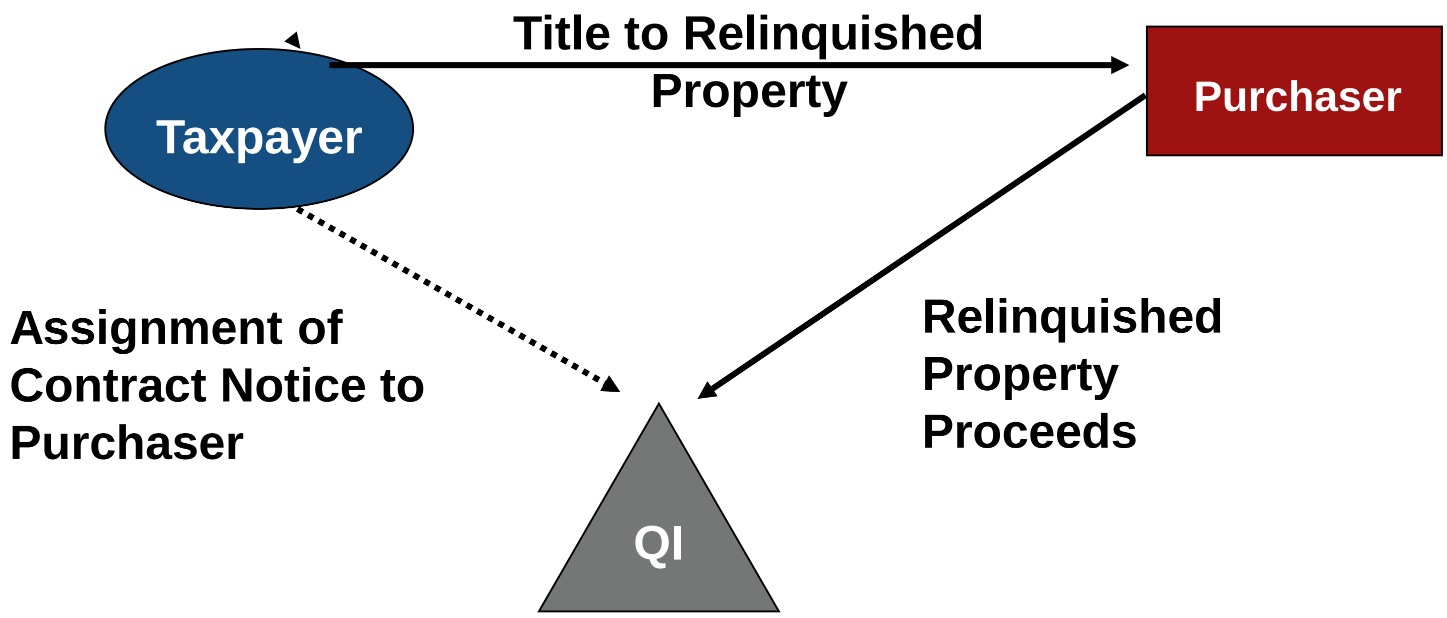
Replacement Property Parking

Sale of Relinquished Property



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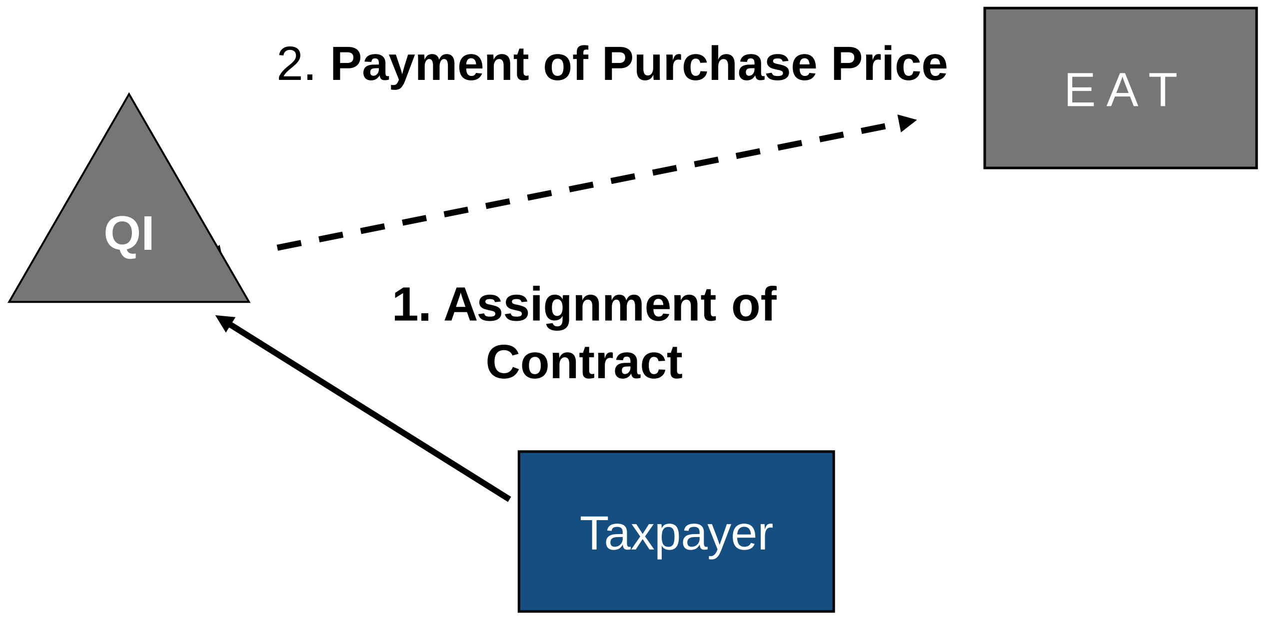
Replacement Property Parking

Transfer of Replacement Property from EAT
Close out of Reverse Exchange

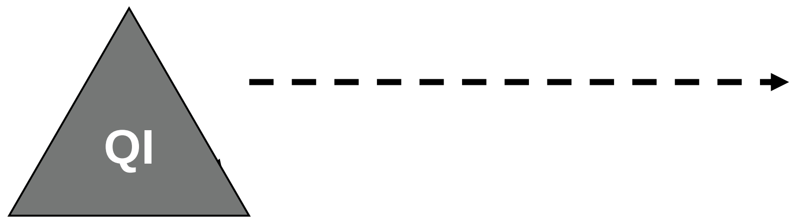


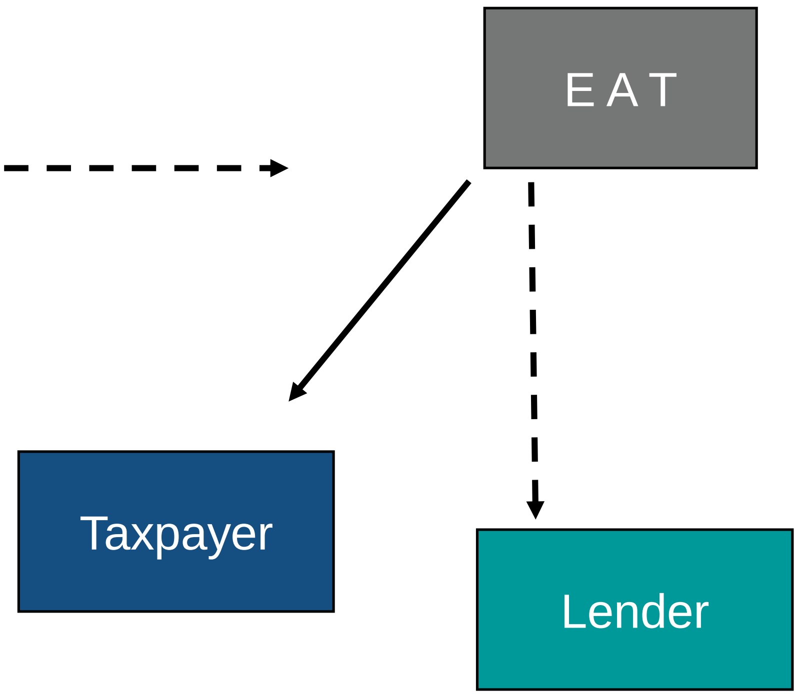
1. Taxpayer assigns its rights under the contract for purchase of the Replacement Property to the QI.

2. Taxpayer then instructs the QI to pay the purchase price to the EAT as Seller of the Replacement Property.

Replacement Property Parking

Transfer of Replacement Property from EAT
Close out of Reverse Exchange





3. EAT uses the proceeds from the Relinquished Property sale to pay down (or pay off) the debt.

4. EAT then transfers the replacement property to the Taxpayer by Assignment of LLC Interests.

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Types of Exchanges

1. Forward Exchanges

2. Reverse Exchanges

3. Build to Suit/Improvement Exchanges

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Common Issues

1. Partnership Exchanges: Drop & Swap;
2. Held for Investment Requirement;
3. Managing Construction/Improvements;
4. Related Party transactions;
5. Vacation homes/personal use property;
6. Split Treatment Exchanges;
7. Seller Financing;
8. Closing Costs & Lender Fees;
9. Earnest Money Deposits.

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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 $50 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
Clients 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
A client depends on the QI to properly document and facilitate the 1031 Exchange. Our core team has been together for over 25 years. Completed over 60,000 transactions nationwide. We have been in business since 1989.

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The CDEC Team has decades of experience and great bench strength.

Let us help you navigate through the complexities of your client’s exchanges.

Thank you for the opportunity to be of service.

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