140th Annual Meeting

1031 Exchanges
Real Estate/Commercial & Bankruptcy Track

4:00 p.m.-4:45 p.m.

Presented by

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Wednesday, June 19, 2013
(Real Estate/Commercial & Bankruptcy Track)

TAX NAVIGATION IN A NEW ERA

1031 Techniques and Strategies

David A. Brown, JD, CES
President, IPE 1031

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Sale of $1,000,000 Asset in 2012

TAX CALCULATION:		
Federal Capital Gains Tax:	$150,000	($1,000,000 x 15%)
State Capital Gains Tax:	$ 90,000	($1,000,000 x 9%)
Total Tax Paid:	$240,000	
Funds After Tax:	**$760,000**	

(Assumes $0 Basis)

2013 and Beyond: Goodbye 15% Capital Gains Tax Rate Hello 25% for High Earners

Gain due to appreciation
- 15% up to $200,000 (single) $250,000 (married)
- 3.8% Medicare Surtax for earners over $200,000 (single) $250,000 (married)
- 20% for earners over $400,000 (single) $450,000 (married) plus 1.2% phase-out of itemized deductions

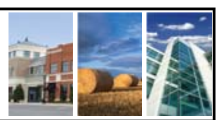
Gain due to depreciation (25%)
Iowa capital gains (Ordinary Income – up to 8.98%)
Gain on properties held less than one year (Ordinary Income)

34% (IA) potential tax for income over $450,000

Sale of $1,000,000 Asset in 2013

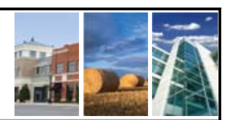
TAX CALCULATION:			
Federal Capital Gains Tax:	$200,000	($1,000,000 x 20%)	
Federal Medicare Surcharge:	$ 50,000	($1,000,000 x 5%)	
State Capital Gains Tax:	$ 90,000	($1,000,000 x 9%)	
Total Tax Paid:	**$340,000**		
Funds After Tax:	$660,000	v.	$1,000,000

(Assumes $0 Basis)



Four Options with a Property

1. Hold
2. Cash Out
3. Installment Sale
4. 1031 Exchange



Reasons to Hold

- Strong asset (cash flow, future appreciation)
- Simply don't want to pay tax
- Estate planning - stepped up basis for heirs

Reasons to Cash Out

- Reduce debt
- Low capital gains tax rates for 2012
- Diversify into different asset classes
- Start a 1031 exchange but can't find suitably priced replacement property

Installment Sale – Receive Payments Over Time

GAIN CALCULATION:

$ 1,000,000	Sale Price of Property (2013)
- 200,000	Basis of Property (1988 Purchase)
800,000	Gain

Year Taxed	Funds Received	Amount Basis	Taxed	Tax
2013 (15% Fed / 7% State)	$200,000	$40,000	$160,000	$35,200
2014 (22%)	$200,000	$40,000	$160,000	$35,200
2015 (22%)	$200,000	$40,000	$160,000	$35,200
2016 (22%)	$200,000	$40,000	$160,000	$35,200
2017 (22%)	$200,000	$40,000	$160,000	$35,200
Total	**$1,000,000**	**$200,000**	**$800,000**	**$176,000**

Benefit of Section 1031?

- Held for investment or used in trade or business
- Use all proceeds from the sale of old property to buy new property
- Interest-free loan from Uncle Sam

Red Flag No. 1: Not Asking the Right Questions

- Type of Property Being Relinquished
- Length of Ownership
- FMV / Basis / Gain of Relinquished
- Debt on the Property
- How Title is Held / Nature of Entity Business
- Replacement Property Type
- Value of Replacement Property
- Improvements
- Related Party Replacement Property Seller
- How Title to be Held for Replacement

Qualifying Like-Kind Properties Include:

- Rental properties (houses, duplexes, apartment complexes, etc.)
- Farms and farm land (except homestead)
- Office buildings
- Retail spaces (strip malls, stand alone stores, gas stations, etc.)
- Industrial and warehouse facilities
- Mini-storage units
- Raw land (land held for speculation)
- Golf courses and sporting complexes
- Vacation homes – under very limited circumstances
- Partial Interests – TIC %, permanent conservation easements, leases (30 Years or More)

Retirement Planning

Farmer and spouse own 1000 acres:

2012: Sell 100 acres for $500,000 (In two years, taxpayer plans to retire to Boise, ID, to be near grandkids, Arizona, Guam or Northern Mariana Islands).

2012: Exchange farmland into Boise loft – rent it for two years (couple has an indeterminate intent to eventually use it for personal residence).

2014: Sell farmhouse (personal residence – § 121 gain exclusion).

2014: Move into Boise loft (now converted to a personal residence).

2017: Want to move south to Hot Springs, Arkansas – (§ 121 gain exclusion).

Red Flag No. 2: Fear and Lack of Use of Reverse and Improvement Exchanges

Exchangers may be confronted with situations where they cannot sell relinquished property(ies) before they buy replacement property(ies):

- Exceptional purchasing opportunities
- Relinquished property cannot be sold before replacement property closing
- Improvements are to be built on replacement property
- Planned events: Increased time flexibility

Red Flag No. 3: Purchase Agreement Defects

- Assignable
  - Foreclosures specifically
- Cooperation Language Options
- All Exchangers Parties to the Contract
- Closing Dates in Sequence (Reverse Exchange)
- 1031 Disclosure in Replacement Property Agreement

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Red Flag No. 4: The Disqualified Qualified Intermediary

- Must designate QI prior to close of relinquished property
  - Cannot simply hold funds in escrow
- Cannot be agent of taxpayer
- Attribution Rules: Who is the owner of the QI?
- Exchange Funds Practices

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Red Flag No. 5: Trading Down in Value

To defer <u>all</u> capital gain:

1. The replacement property must have a value that is equal to or greater than the sale price of the relinquished property.
2. The exchanger must place all of the equity from the sale of their relinquished property into the replacement property.
3. The replacement property must have debt that is equal to or greater than that of the relinquished property.

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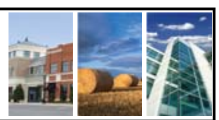

Red Flag No. 5: Trading Down in Value

	Relinquished Property	Replacement Property
Sale Price:	$1,000,000	$ 800,000 ↓
Debt:	$ 500,000	$ 300,000 ↓
Equity:	$ 500,000	$ 500,000 =

If the taxpayer "trades down" in sale price, debt, or equity, he/she will be taxed on the amount of the "trade down" up to their realized gain.

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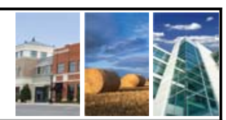

Receipt of Cash <u>Always</u> Taxable

	Relinquished Property	Replacement Property
Sale Price:	$1,000,000	$1,200,000 ↑
Debt:	$ 500,000	$ 800,000 ↑
Equity:	$ 500,000	$ 400,000 ↓

The exchanger acquired replacement property worth $200,000 more than the value of relinquished property and received $100,000 cash from the exchange. Cash is not like-kind to real estate. Mortgage debt incurred does not offset cash boot received. The exchanger will pay tax on $100,000.

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Pre and Post Exchange Financing

- Case law supports proposition that a taxpayer can take equity out of property before or after the exchange.
  - Should not be done in anticipation of an exchange
  - Best to have an independent economic significance from the exchange
  - Dangers: The I.R.S. does not condone

Red Flag No. 6: Properties Held for Resale, Dealers, Flippers and Non-qualifying Uses

- Avoiding Dealer Status
- Properties Held for Resale Do Not Qualify
  - Contract Rights
  - Flippers
  - Apartment to Condo Conversions

Red Flag No. 7: Improper Documentation of the Exchange

- Notice of Assignment
  - All Parties
  - Signed by all non-exchanging parties
- Partial Assignments
  - Boot excepted
  - Personal residence (relinquished and replacement)
  - Replacement: Intent to exchange into specific parcel
- Real Estate Installment Sale
  - Relinquished
  - Replacement

Red Flag No. 7: Improper Documentation of the Exchange

- Closing Documents
  - Deed Review
  - Transfer of 100% of LLC Units
  - Title Opinion / Commitment Review
  - Signed Closing Instructions
  - Settlement Statement Review
- Identification Letter
  - Signed By All Parties to the Exchange
  - Must be Specific
  - Improvements listed
- Time Periods
  - 45 Day ID Period: No room for being the accommodating accommodator
  - 180 Day Exchange Period: Request extension of tax return

Red Flag No. 7: Improper Documentation of the Exchange

- Early Release of Funds
- Copy of File for Exchanger and Advisor

Red Flag No. 8: Settlement Statement Problems

- Permitted Exchange Expenses
- Debt Payoffs Related to Relinquished Property
- Rents and Deposits
- All Exchange Equity Applied to Replacement Purchase
- Over Financing on Replacement

Red Flag No. 9: Prohibited Related Party Transactions

- Basic Rule: Related parties can exchange property if both parties hold replacement properties for two years.
- **MISTAKE:** Common Misconception - An exchanger can acquire replacement property from a related party in a deferred exchange if they sold relinquished property to an unrelated party as long as held for two years.
- I.R.S. prohibits basis shifting.

Red Flag No. 10: Partnership Exchanges

- Multi-member LLCs are Typically Partnerships for Tax Purposes
- Drop and Swap
- Swap and Drop
- Special Allocations to Retiring Partners

Use Us As Your Resource

Please do not hesitate to call us if you have questions about a client's transaction or Section 1031 generally.

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TOP TEN EXCHANGE RED FLAGS

QUALIFIED INTERMEDIARY SERVICES

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1. **The Disqualified Qualified Intermediary:** To effectuate a deferred 1031 exchange, taxpayers must utilize the qualified intermediary safe harbor. Any person serving as a qualified intermediary for the taxpayer cannot be a disqualified party. Examples of disqualified parties include the taxpayer's attorneys, accountants, real estate agents/brokers and employees. Under the Internal Revenue Code's attribution rules, the disqualification cannot be removed by setting up a separate legal entity owned by the disqualified party or by a disqualified party's family member. Taxpayers seeking the services of a qualified intermediary company should inquire into the entity's ownership to ensure the exchange will not be disqualified as a result of its ownership.

2. **Not Asking the Right Questions:** While most exchangers and practitioners appreciate the complexities of Section 1031, some hold the opinion that most exchanges are "plain vanilla." Rarely is this the case. By asking the right questions from the start, a seasoned qualified intermediary can uncover problems and offer alternative structures. Planning and careful consultation with the qualified intermediary, as well as tax and legal advisors, is the key to a successful exchange transaction.

3. **Unassignable Real Estate Purchase Agreements:** While it is common practice to place exchange cooperation language in purchase agreements, a critical component of the language is often omitted. Under Section 1031, the exchanging taxpayer must have the ability to assign the agreement to the qualified intermediary. Otherwise, the exchange is invalid on its face. It is crucial to review agreements for the ability to assign, or to amend contractual language to state that the agreement may be assigned by the exchanging taxpayer.

4. **Trading Down in Value:** It is a common misconception that an exchanger can defer all tax on the sale of a relinquished property by simply reinvesting gain on the sale. To defer all tax on an exchange transaction, three general rules must be satisfied. First, the value of the replacement property must be greater to or equal than the value of the relinquished property. Second, all equity from the relinquished property must be reinvested into the replacement property. Third, all debt relief from the relinquished property sale must be replaced with equivalent new debt on the replacement property; or in the alternative, new cash can be substituted for debt relief. While gain on an exchange can be partially deferred, tax will result to the extent a trade down in replacement property value occurs.

5. **Not Utilizing the Power of Reverse Exchanges:** A reverse exchange transaction may be appropriate when a taxpayer desires to take title to a replacement property prior to conveying the relinquished property. Revenue Procedure 2000-37 provides a safe harbor for these situations. To accommodate a reverse exchange, title may be parked with an Exchange Accommodation Titleholder. A reverse exchange can afford an exchanging taxpayer with the ability to locate and acquire the most suitable property with reduced time pressures. Commonly, a taxpayer can utilize a reverse exchange to achieve significant savings on the purchase of the replacement property.

TOP TEN EXCHANGE RED FLAGS

6. **Not Documenting the Exchange:** The documentation requirements of Section 1031 are strict and the requirements for accuracy cannot be overlooked. To effectively accommodate an exchange transaction, a qualified intermediary must ensure that technical exchange document terms, notices, identifications and other requirements are handled correctly. This can only be accomplished by providing specialized services, following specific standards of practice and working closely with an exchanging taxpayer's advisors.

7. **Prohibited Related Party Transactions:** The related party rules under Section 1031 are complex and confusing. Misapplications of these rules are a common reason for failed exchange transactions. It is a common misconception that a taxpayer can purchase replacement property from a related party in a deferred exchange transaction provided the property is held for two years. This is incorrect as set forth in Revenue Ruling 2002-83, wherein it states that related party replacement property purchases are specifically prohibited. Exceptions and structuring alternatives do exist. However, careful analysis of the underlying facts and circumstances must occur.

8. **Flipper and Dealer Status:** To qualify for Section 1031 treatment, property must be held for investment or use in a trade or business. This is distinguished from properties held for sale or as inventory. Property flippers and dealers are not eligible for 1031 treatment. With advanced planning, it is possible to structure ownership arrangements to afford the use of Section 1031 for properties held in an investment context.

9. **Settlement Statement Problems:** Careful attention must be paid to settlement statements for properties involved in a 1031 exchange. Besides documenting the flow of funds and intent of the parties, it is important to avoid the use of exchange proceeds to pay for non-qualifying expenses such as rents and deposit credits, loan costs and expenses unrelated to the property but listed on the settlement statement. Further, the replacement property cannot be over-financed. Mishandled expenses and loan proceeds can result in unexpected boot at a minimum, or an exchange that is otherwise outside the safe harbor.

10. **Partnership Issues:** Many investment property owners hold property in multi-member LLCs, most of which are considered partnerships for tax purposes. While partners may desire to sell the partnership property and exchange into separate replacement properties, this is not permitted under Section 1031. If undertaken sufficiently in advance of a disposition of partnership property, a partnership may be terminated and converted into an exchangeable tenancy-in-common interest. Further, structuring alternatives within the partnership may be utilized to allow retiring partners to exit. Advanced planning by the exchanging taxpayer is crucial.

I.R.C. § 1031 REFERENCE GUIDE

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I.R.C. § 1031 PURPOSE:

Section 1031 allows owners of business and investment property to defer payment of capital gains taxes by reinvesting all proceeds from the sale of a currently owned property (relinquished property) into new like-kind property (replacement property).

TYPES OF EXCHANGES:

Delayed: A delayed exchange occurs when a taxpayer, utilizing the services of a qualified intermediary, first sells relinquished property and subsequently acquires replacement property. Subject to certain rules, the taxpayer has up to 180 days from the transfer of the relinquished property to acquire replacement property.

Reverse: A reverse exchange occurs when a taxpayer, utilizing the services of a qualified intermediary and an exchange accommodation titleholder (EAT), acquires replacement property before disposing of relinquished property. In a reverse exchange, § 1031 requires that the EAT take actual title to the replacement property until the relinquished property is sold. A reverse exchange benefits a taxpayer when the taxpayer must purchase the replacement property before being able to sell relinquished property. To fall within the safe harbor of § 1031, the transaction must be completed within the 180-day time period.

Improvement: Taxpayers who desire to construct improvements on replacement property, utilizing relinquished property proceeds on deposit with a qualified intermediary, can do so by structuring the transaction as an improvement exchange. Improvement exchanges are similar to reverse exchanges in that an EAT must take actual title to the replacement property while it is under construction. To fall within the safe harbor of § 1031, the transaction must be completed within the 180-day time period.

Non-Safe Harbor Build-to-Suit: In many circumstances, improvement exchanges cannot be completed within the 180-day safe-harbor period. For such occasions, a § 1031 exchange can be structured outside of the safe-harbor provisions of § 1031 and still qualify for § 1031 treatment. In this instance, a third party must take actual title to the property and have a beneficial and significant interest in the transaction.

QUALIFYING PROPERTY:

Real Property: Generally speaking, nearly all types of real estate are classified as like-kind to each other. So long as a piece of real property is used for investment or for use in a business, it will qualify for § 1031 treatment. Examples of real properties that can be exchanged for one another include the following: rental properties, farms and ranches, office buildings, motels and hotels, golf courses, raw land, industrial properties, retail properties, storage units, vacation homes under certain limitations, and properties leased for 30 years or more.

Personal Property: Personal property can be exchanged utilizing § 1031 so long as it is used for investment or used in a trade or business, and is traded for like-kind property. This may become an issue when businesses or apartment complexes are traded and items of personal property (stoves, washers, dryers, refrigerators, etc.) exceed 15% of the underlying real estate's value.

REASONS TO EXCHANGE:

Generally speaking, the principal advantage of a § 1031 exchange is the ability to use the entire equity of a property owned by a taxpayer to acquire replacement property. Tax consequences of selling property are taken out of the equation and taxpayers are free to move equity into more lucrative or appropriate investments. Some specific reasons for using § 1031 are as follows:

Consolidation or Diversification: A taxpayer may wish to decrease the number of properties held by exchanging out of multiple relinquished properties into fewer or single replacement properties. The effect could be reduced managerial and maintenance burdens. Alternatively, a taxpayer may wish to exchange out of one high value property into multiple properties to limit investment exposures, diversify holdings, or increase cash flow.

Relocation of Investment: Taxpayers who relocate from one part of the country to another can utilize § 1031 to move real property investments to the taxpayer's new location and avoid payment of capital gains tax.

Stepped-up Basis for Heirs: Heirs who inherit property from a taxpayer who has utilized § 1031 to defer taxable gain through the life of the investment(s) will acquire the property at a stepped-up basis. The effect being that the heir's basis equals the fair market value (FMV) of the property at the time of the taxpayer's death and no tax will be paid by the heir to the extent the sale price does not exceed FMV at the time of death.

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QUALIFIED INTERMEDIARY SERVICES

IMPORTANT RULES AND RESTRICTIONS:

45-Day Identification Rule: After a taxpayer sells the original relinquished property, replacement properties must be identified by the 45th day following the transfer.

Three-Property Identification Rule: A taxpayer may identify up to three properties without regard to the relinquished property's FMV.

200% Identification Rule: In the alternative to the Three-Property Rule, a taxpayer may identify any number of properties, so long as the aggregate FMV of all identified properties does not exceed 200% of the FMV of the relinquished property on the date it was sold.

95% Identification Rule: A taxpayer may identify any number of properties, without regard to FMV, so long as 95% of the identified properties are actually acquired.

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180-Day Exchange Period Rule: After identification, closing on all replacement properties must occur at the end of the 180th day following the transfer of the relinquished property; or, the due date of the taxpayer's federal tax return for the year in which the property was relinquished, including extensions, whichever is earlier.

TO AVOID ALL TAXABLE GAIN, the general rule is that taxpayers must acquire replacement property that has a FMV equal to or greater than the FMV of the relinquished property, and all equity must be reinvested into the replacement property.

SAMPLE COOPERATION LANGUAGE:

Purchase and sale contracts for § 1031 transactions should contain cooperation language. An example follows. However, the sample language should be modified to fit the specifics of each particular transaction.

> It is the intention of Seller to transfer the subject property pursuant to Internal Revenue Code Section 1031, which sets forth the requirements for tax-deferred real estate exchanges. Seller's rights and obligations under this and future agreements may be assigned to a qualified intermediary for the purpose of completing an exchange. Buyer agrees to cooperate with Seller in a manner necessary to enable Seller to complete an exchange. Such cooperation shall be at no additional cost or liability to Buyer.

TAX DEFERRED EXCHANGES UNDER IRC §1031

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I. IRC §1031 OVERVIEW

Real estate and property owners who hold property for investment or for productive use in a trade or business are eligible for tax deferment of capital gains taxes under Section 1031 of the Internal Revenue Code (I.R.C.). Section 1031 should not be confused with the personal residence capital gains tax exemption provisions of I.R.C. Section 121.

By utilizing Section 1031, a taxpayer can defer payment of capital gains taxes each time an exchange is done until an exchanged property is sold and cash proceeds are received. A qualifying taxpayer who sells property may reinvest the entire proceeds of the sale, including amounts ordinarily paid as capital gains tax, into one or more “like-kind” properties. “Like-kind” property is property that is similar in nature or character. Examples of like-kind property include: rental properties, farms and ranches, offices, motels and hotels, golf courses, raw land, retail properties, industrial properties, and properties leased for thirty years or more. Personal property is not like-kind to real property.

Most tax-deferred exchanges are classified as delayed exchanges. A basic delayed exchange occurs when a taxpayer sells “relinquished” property and exchanges it for “replacement” property within a 180-day time period. The taxpayer must adhere to other specific procedures and time period limitations.

To accomplish a successful tax-deferred exchange, most taxpayers specifically structure their transaction so that it falls within an IRS safe-harbor. The most common safe harbor method for structuring a tax-deferred exchange is for an exchanging taxpayer to utilize the services of a qualified intermediary. Careful attention must be paid by the exchanging taxpayer to ensure that a qualified intermediary has been hired prior to the sale of the relinquished property and to ensure that the taxpayer or the taxpayer’s agents do not receive proceeds from the sale.

Certain persons are disqualified by Section 1031 from serving in the capacity of a qualified intermediary. Disqualified parties include a taxpaying exchangor’s employee, attorney, accountant, investment banker/broker or real estate agent/broker. This restriction applies if the taxpayer’s agent has served in such a capacity within the two years prior to the exchange transaction. Disqualified parties additionally include certain family members such as parents, siblings, spouses, and children; and certain business entities owned by the taxpayer. This is not an exhaustive list of persons who may be disqualified.

It is important to note that Section 1031 is a tax deferral tool and not a tax avoidance tool. Should a taxpayer cash out of the investment during his/her lifetime, tax will be owed on all capital gain built into the asset during the ownership period. Although tax may eventually be paid upon liquidation of the asset, some circumstances exist where the tax can be eliminated. For example, if a taxpayer exchanges for the life of the investment, without cashing out, his/her heirs will inherit the the property with a stepped-up basis. The result is that if the heir sells the property after the taxpayer's death, no tax will be owed to the extent the sale price does not exceed the new stepped-up basis.

II. EXCHANGE TERMINOLOGY:

Adjusted Basis:

The net cost of an asset after taking into account adjustments such as depreciation, expenses and improvements.

Boot:

Property received in a Section 1031 exchange that is not like-kind to the relinquished property.

Capital Gain:

The difference between what was paid for an asset and what was received when the asset is sold.

Cost Basis:

The original acquisition price of a capital asset.

Delayed Exchange:

When a taxpayer, most commonly utilizing the qualified intermediary safe-harbor, first sells relinquished property and subsequently acquires replacement property. Subject to certain rules, the taxpayer has up to 180 days from the transfer of the relinquished property to acquire replacement property.

Direct Deeding:

The process under Section 1031 of the Internal Revenue Code that permits the parties to deed properties directly between each other without passing through the qualified intermediary.

Exchangor:

The party desiring to execute a Section 1031 tax-deferred exchange. The Exchangor is often referred to as the “Taxpayer.”

Exchange Accommodation Titleholder (EAT):

A separate corporate entity (typically a limited liability company) formed by a qualified intermediary company to hold property for a reverse exchange.

Exchange Period:

The 180-day period of time, beginning on the date of closing on the relinquished property, during which an exchanger must acquire replacement property.

Identification Period:

The 45-day period of time, beginning on the date of closing on the relinquished property, during which an exchangor can identify replacement properties.

Improvement Exchange:

Exchangors that desire to construct improvements on replacement property, utilizing relinquished property proceeds on deposit with a qualified intermediary, can do so by structuring the transaction as an improvement exchange. Improvement exchanges are similar to reverse exchanges in that an EAT must take actual title to the replacement property while it is under construction. To fall within the safe-harbor of Section 1031, the transaction must be completed within the 180-day time period.

Non-Safe-Harbor Build-to-Suit Exchange:

In some circumstances, improvement exchanges cannot be completed within the 180-day safe-harbor period. For such occasions, a Section 1031 exchange can be structured outside the safe-harbor provisions of Section 1031 and still qualify for tax-deferral treatment. In this instance, a third party must take actual title to the property and have a beneficial and significant interest in the transaction.

Qualified Intermediary:

An independent third party who acts as a conduit and facilitator for a Section 1031 exchange. Duties of a qualified intermediary typically include preparation of exchange documentation, holding of relinquished property proceeds in trust, and ensuring that the transaction complies with IRS safe-harbor guidelines. The qualified intermediary cannot be a person who is the attorney, relative of, CPA, investment banker/adviser, employee or realtor of the owner of the relinquished property. Typically the qualified intermediary is an independent company that specializes in this work.

Relinquished Property:

Property currently owned by an exchangor that will be traded for new property.

Replacement Property:

Property to be acquired by an exchangor in place of the exchangor’s old property.

Reverse Exchange:

A reverse exchange occurs when an exchangor, utilizing the services of a qualified intermediary and/or an exchange accommodation titleholder (EAT), acquires replacement property before disposing of relinquished property. In a reverse exchange under the safe-harbor, Section 1031 requires that the EAT take actual title to the replacement property until the relinquished property is sold. Reverse exchanges benefit an exchangor when the taxpayer must purchase the replacement property before being able to sell the relinquished property. To fall within the safe-harbor of Section 1031, the transaction must be completed within a 180-day time period.

Safe Harbor:

A legal procedure offered by the IRS to permit taxpayers to structure an exchange transaction with certainty that it will be acceptable.

Simultaneous Exchange:

When two parties, at the same time, trade property using one escrow. If structured correctly, a qualified intermediary is not required.

III. A TYPICAL TRANSACTION

Able Farmer owns farmland outside his home county (relinquished property) and is offered a very attractive price for the property. Able's neighbor offers to sell him farmland (replacement property) that adjoins a parcel Abel owns in the county where his farming operation is located. Able wishes to exchange the remotely located farmland for the farmland located near his farming operation, especially if there are no tax consequences.

The contract is drawn between Able and the buyer of his relinquished property. In the course of drawing up the contract, his tax/legal advisor includes 1031 cooperation language and ensures the contract is assignable to a qualified intermediary. Further, tax advisor suggests that client contact a qualified intermediary company as soon as possible. In the alternative, tax advisor prepares exchange documents setting up a non-disqualified entity as qualified intermediary. Qualified intermediary consults with client and prepares exchange documents which include an engagement letter, exchange agreement, and an assignment and notice of assignment of purchase contract. Closing instructions are provided to the closing agent. The documents are signed by Able, his wife, and by the qualified intermediary. Qualified intermediary must provide all parties to the contract with notice of the assignment of the purchase contract. Failure to do so may result in a failed exchange transaction. Closing for the relinquished property occurs and the net proceeds from the sale are transferred directly from the closing agent to the exchange account held by qualified intermediary. Able and his advisors are careful to not receive the exchange funds so as to prevent automatic disqualification of the exchange transaction.

Having received notification of exchange deadlines and identification requirements from qualified intermediary, Able now has 45 days from the date of closing (March 1) to identify replacement property(ies). Note that all deadlines start from the date when the benefits and burdens of ownership are transferred (closing) and not from the date of execution of the purchase contract.

The replacement property must be of like-kind and may be any real estate held for investment or for use in a trade or business. The identification must describe the property with particularity, as defied by the Regulations, and if there is a question if it is going to be replaced by this property or another, up to three properties can be identified. In the alternative, Able can identify under two other identification rules called the “200% Rule” and the “95% Rule.” A letter identifying the replacement property must be signed by the person(s) doing the exchange and sent to the qualified intermediary. If the identification letter is not sent to qualified intermediary by midnight on the 45th day following the relinquished property transfer, the exchange fails.

Able now has 180 days from March 1st to complete the acquisition of the property to be acquired.

CAUTION: If settlement of the sale was between October 17, 2012, to December 31, 2012, an individual would only have until April 15, 2013, to complete the purchase of the property to be acquired. In the case of a corporation, March 15 would be the deadline to complete the transaction. An extension of time to file the tax return could be requested and then one would have that additional time as per the extension.

At or before the time of closing for the replacement property, **qualified intermediary prepares closing instructions for the replacement** property closing agent, prepares an assignment to qualified intermediary of the new purchase contract and wires proceeds to the closing agent or directly to the seller of the property to be acquired. Qualified intermediary must provide all parties to the contract with notice of the assignment of the purchase contract. Failure to do so will result in a failed exchange transaction. Deeds for both the relinquished property and replacement property transfers are direct between Able and the other parties. Qualified intermediary is never placed into the chain of title because IRS regulations permit direct deeding between parties when the purchase contract has been assigned to qualified intermediary.

The basis of the property acquired is the same as the basis of the relinquished property. It is a carry-over basis and hence, remains the same. It will be increased by any additional investment into the property. Future improvements and future depreciation will, of course, affect the basis.

CAUTION: Depreciation which may be recaptured, such as depreciation on buildings and on tile, follows the property and will be an issue upon sale of the property to be acquired.

IV. BASIC SECTION 1031 RULES

A. 45-DAY IDENTIFICATION DEADLINE

After the taxpayer sells the original relinquished property, two very important time limitations come into play. The limitations are classified as the 45-day identification period and the 180-day exchange period. Generally, there are no exceptions or extensions. Should these time periods be violated, the exchange will fail. Weekends and holidays are included in these two time periods.

The 45-day identification period starts after the sale of the original relinquished property. After the closing on the relinquished property, the exchangor has 45 days to identify the replacement property. In the case of an exchange involving multiple relinquished properties, the 45-day exchange period begins upon the sale of the first relinquished property.

Replacement property that is acquired before the 45-day identification deadline is deemed identified for exchange purposes and no identification letter is required. For properties that do not close prior to the deadline, exchange identification occurs when the taxpayer sends a letter to the qualified intermediary designating the properties that will be acquired. The identification letter must be in writing and sent to the qualified intermediary prior to midnight on the 45th day. I.R.S. regulations require that the letter described the property with as much particularity as possible. In order to be valid, the letter must be signed by all exchanging taxpayers. Properties are identified by their street address and/or legal description. If less than a 100% ownership interest will be acquired in the property, this fact must be stated on the identification letter. If improvements are to be incorporated into the property prior to acquisition of it by the taxpayer, the improvements must be included in the description. Property that is not specifically identified will not qualify toward the exchange.

B. PROPERTY IDENTIFICATION RULES:

A taxpayer can identify property using one of three rules. The taxpayer can choose one rule only. Under the "3-Property Rule" a taxpayer can identify up to three properties, without consideration of the fair market value for each. The taxpayer need not purchase all of the properties identified.

Under the "200% Rule", a taxpayer can identify any number of properties so long as the aggregate fair market value of all identified properties does not exceed 200% of the value of the relinquished properties. For example, assume taxpayer sells one relinquished property for $1,000,000. Two hundred percent of the value of the relinquished property equals $2,000,000. Under this scenario, the taxpayer could identify eight replacement properties worth $250,000 each. Similarly, four replacement properties could be identified with values of $750,000, $600,000, $400,000 and $250,000.

The "95% Rule" provides that any number of properties may be identified as long as the taxpayer closes on 95% of the fair market value of those identified by the 180th day. Using the example above, assume taxpayer sells his relinquished property for $1,000,000. Taxpayer wants to identify ten properties worth $500,000 each, for a total of $5,000,000. Neither the 3-Property or 200% Rules will work under this scenario. Therefore, using the 95% Rule, the taxpayer identifies all ten properties. In order for his exchange to qualify, taxpayer must acquire all ten identified properties or a sufficient amount of property equating to at least $4,750,000, which is equal to 95% of the value of the identified property.

Example identification forms follow:

To:

Re: **"3-Property Rule"** Identification Letter – EXCHANGER I.R.C. §1031 Exchange

I/We hereby identify the following property(ies) as replacement property for our tax-deferred exchange under the "3-property Rule":

(1) Street Address and/or Legal Description of Property:

Percentage of Property to be purchased: _______ %

(2) Street Address and/or Legal Description of Property:

Percentage of Property to be Purchased: _______%

(3) Street Address and/or Legal Description of Property:

Percentage of Property to be Purchased: _______%

____ I intend to only acquire one of the above properties (check box if applicable).

NOTE: PLEASE REFER TO LANGUAGE CONTAINED IN THE OPENING FEE AGREEMENT LETTER AND EXCHANGE AGREEMENT WITH REGARD TO THE LIMITATION ON YOUR CCESS TO THE EXCHANGE FUNDS IF YOU DO NOT COMPLETE YOUR EXCHANGE.

NOTE: YOU MUST CHOOSE BETWEEN THE "3-PROPERTY," "200%," OR "95%" RULES. DO NOT IDENTIFY USING ALL THREE LETTERS

Sincerely,

____

EXCHANGER Date

To:

Re: **"200% Rule"** Identification Letter – EXCHANGER I.R.C. §1301 Exchange

I/We hereby identify the following property(ies) as replacement property for our tax-deferred exchange pursuant to the "200% rule":

Fair Market Value of Relinquished Property $ ________________

____

Street Address and/or legal description Property Fair Market Value

1. $ ________________

Percentage of Property to be Purchased: ______%

2. $ ________________

Percentage of Property to be Purchased: ______%

3. $ ________________

Percentage of Property to be Purchased: _____%

4. $ _______________

Percentage of Property to be Purchased: _____%

5. $ _______________

Percentage of Property to be Purchased: _____%

6. $ _______________

Percentage of Property to be Purchased: _____%

Total Fair Market Value of Identified Properties; $ _______________
(CANNOT EXCEED 200% OF RELINQUISHED
PROPERTY FAIR MARKET VALUE ($___________))

NOTE: PLEASE REFER TO LANGUAGE CONTAINED IN THE OPENING FEE AGREEMENT LETTER AND EXCHANGE AGREEMENT WITH REGARD TO THE LIMITATION ON YOUR ACCESS TO THE EXCHANGE FUNDS IF YOU DO NOT COMPLETE YOUR EXCHANGE.

NOTE: YOU MUST CHOOSE BETWEEN THE “3-PROPERTY,” “200%,” OR “95%” RULES. DO NOT IDENTIFY USING ALL THREE LETTERS

Sincerely,

____

EXCHANGER Date

C. THE 180-DAY EXCHANGE PERIOD:

After proper identification of the replacement properties, closing must be completed by the earlier of the following:

(1) 180 days following transfer of the exchangor's relinquished property; or in the event of multiple relinquished properties, 180 days following the transfer of the first property; or

(2) Due date for the exchangor's federal income tax return for the year in which the old property was relinquished. In some cases, an extension for filing the exchangor's income tax return must be requested in order to receive the entire 180 days.

As an example, assume a taxpayer sells her relinquished property on December 30, 2012. As the I.R.S. requires for the exchange to be reported on Taxpayer's 2012 tax return, the exchange must be completed prior to the due date of Taxpayer's federal income tax return in 2013 (March 15 for 3corporations and April 15 for individuals). As a result, taxpayer's exchange period is cut to 106 days. To receive the full 180 days, the exchangor's advisor must file a request for an extension.

D. FINANCIAL STRUCTURE RULE:

Tax will be due in an exchange unless the taxpayer is placed in the same financial position with the replacement property as he/she was with the relinquished property. If the taxpayer receives cash or is relieved of debt, taxable gain will exist to the extent of cash received for debt relieved.

In order for a taxpayer to avoid all tax on the sale of relinquished property, taxpayers must follow three rules. First, the replacement property must have a fair market value greater to or equal than the sale price of the relinquished property. Second, all equity from the relinquished property must be reinvested into the replacement property. Finally, the debt incurred on the replacement property purchase must be equal to or greater than the debt given up on the relinquished property.

A common misconception exists that a taxpayer can simply reinvest the gain from the sale of the relinquished property to defer the tax on the sale. For instance, assume Taxpayer sells property with a basis of $200,000 for $500,000. Taxpayer may assume that the exchange would be non-taxable as long as the $300,000 gain was reinvested into replacement property. To the contrary, tax would be incurred to the extent of the trade down in value. In other terms, the taxable gain would equal $200,000 ($500,000 relinquished sale price minus the $300,000 purchase price) due to the fact that $200,000 boot was received, be it in the form of cash or relief of debt. Gain that would be tax deferred equals the difference between the basis and the replacement property purchase price, or $100,000.

V. REASONS A TAXPAYER SHOULD CONSIDER A SECTION 1031 EXCHANGE

The principal advantage of a Section 1031 tax-deferred exchange is the ability to use the entire equity of a property owned by a taxpayer to acquire replacement property. Taxpayers who have held onto properties for years because of the tax consequences of selling have the freedom to move their equity into more lucrative or appropriate properties. If a taxpayer intends to continue investing in like-kind property, an exchange is usually the preferable alternative to a sale and a purchase. Reasons for a taxpayer to participate in a Section 1031 exchange are as follows:

A. CONSOLIDATION OR DIVERSIFICATION OF INVESTMENTS:

A taxpayer who has acquired a number of properties over the years may desire to reduce the number of his or her holdings by replacing separate properties with a single property or a reduced number of properties, all having equal or greater value than the original holdings. This method of exchanging often has the effect of reducing managerial burdens associated with day-to-day emergencies, collection of rents, and maintenance of the properties.

On the other hand, a taxpayer may desire to diversify one high value investment property into two or more different properties. In this scenario, taxpayers can reallocate investments into newer properties and/or different neighborhoods. The effect of such an exchange can include lower maintenance expenses, lower vacancy rates, and/or greater opportunity for appreciation.

B. GREATER CASH FLOW:

Many taxpayers own raw land. Raw land may be a cash drain because of tax obligations and may not generate adequate cash payments. If the taxpayer wishes to convert such property into a cash flow asset, Section 1031 can be used to avoid the tax on the gain created by a desire to put such property to a new use.

C. RELOCATION OF INVESTMENT:

Taxpayers often relocate to different parts of their state or the United States. Relocations may be the result of a new career or business opportunity, the need for larger operation facilities, the desire to take advantage of a different state's non-taxing of income, or a retirement move. In these circumstances, investors may not want to be absentee landlords. An investment in income-producing property managed by a taxpayer can be relocated. To avoid taxes on gain from the sale of the original relinquished property, a taxpayer can take advantage of Section 1031.

D. "STEPPED-UP BASIS" FOR HEIRS:

Should a taxpayer hold investment property until death, and taxable gain has been deferred through the life of an investment(s) by utilizing Section 1031, the recognition of gain is eliminated from an income tax standpoint due to heirs receiving the property at a "stepped-up basis." In effect, heirs inherit the property with a basis equivalent to the fair market value of the property at the taxpayer's death. In this situation, heirs would not pay tax on the sale of an inherited property to the extent the sale price does not exceed the current fair market value.

E. APPRECIATION – LEVERAGE:

Taxpayers generally invest in real estate in part because of the opportunity to leverage their investment and obtain appreciation on someone else's funds, such as an institutional lender. Taxpayers utilizing Section 1031 are able to obtain greater financing on higher value properties. This is due to Section 1031 allowing ordinarily charged capital gains tax amounts to be applied to the purchase price of the replacement property.

VI. PRACTICE POINTERS FOR A 1031 LIKE-KIND EXCHANGE

Advance planning is required with a non-taxable exchange and all parties should recognize that one cannot convert an ordinary sale into an exchange unless it is done at or before the time the relinquished property closed. A like-kind exchange agreement and other supporting documents must be executed as soon as possible, and prior to closing, so that as the process moves through the various steps all parties are aware that this is not a sale and a reinvestment but instead a non-taxable like-kind exchange.

A. CALCULATING BASIS AND GAIN:

Taxpayers contemplating the tax ramifications of selling a property outright versus completing a 1031 exchange transaction should work closely with their tax advisor to fully evaluate tax consequences. This exercise will most generally result in a realization that total taxes owed on a disposition of property will be significantly greater than 15%.

Formulas for calculating basis and gain follow:

Basis:

Original purchase price (+) improvements (+) acquisition costs (-) depreciation = adjusted basis

Gain:

Sale price (-) adjusted basis (-) cost of sale = realized gain

To calculate the tax that would be owed one must factor in several different taxes, including tax due to appreciation (federal and state capital gains tax) and tax due to depreciation (depreciation recapture). The current federal capital gains tax rate is presently 15% percent. Should the Bush tax cuts not be renewed, capital gains will be taxed at 20%. For single taxpayers reporting income of more than $200,000 and joint filers who exceed a $250,000 income threshold, a new 3.8% Medicare surcharge tax will apply to realized capital gains in 2013. Depreciation recapture for real property is taxed at a maximum rate of 25%. For other types of property, the rate can be equal to a taxpayer's ordinary income tax rate. Although state capital gains tax rates vary from state to state, but can typically add between 5% and 10% to the tax rate.

B. RECAPTURE MAY RESULT FROM AN EXCHANGE OF HIGHLY IMPROVED FARM OR COMMERCIAL PROPERTY (MAINLY IRC 1245 ITEMS) FOR BARE LAND:

Assume one owns a highly improved commercial or farm facility and trades it for bare land. There may be a disposition of Section 1245 personal property with resulting recapture. If replacement property has like and similar improvements equal or exceeding that of the property disposed of, one may be able to avoid the recapture. If improved property is exchanged for unimproved property, recapture may result regardless of the fact that an exchange occurred.

See: Example problems at Section XI of the outline.

C. LIKE-KIND PROPERIES:

Under Section 1031, any real property can be exchanged for any other type of real property so long as the property is "held for investment or used in a trade or business." Examples of qualifying property that can be exchanged for one another include:

- Rental properties (houses, duplexes, apartment complexes, etc.)
- Farms (except homestead of the exchangor)
- Office buildings
- Retail spaces (strip malls, stand alone stores, gas stations, etc.)
- Industrial and warehouse facilities
- Mini-storage units
- Raw land (land held for appreciation)
- Golf courses and other sporting complexes
- Vacation homes - <u>under very limited circumstances</u>
- Conservation easements
- Water rights
- Other partial real property interests

Any of the previously mentioned types of properties are universally exchangeable with one another.

D. NON-INCOME PRODUCING PROPERTY HELD FOR APPRECIATION QUALIFIES FOR EXCHANGE TREATMENT

It is not necessary for exchange property to be income producing. A residential lot or piece of bare ground purchased by an exchangor and held for future sale after appreciation is a property that could be exchanged into other like-kind property.

<u>EXAMPLE:</u> April Schauer purchased unimproved residential lots and bare farmland near Oblong, Illinois. April derives no present income from the properties but anticipates that the lots and farmland will appreciate in value. April can exchange the properties for other like-kind property.

<u>EXAMPLE:</u> Bill trades farmland that he uses in his farming operation for other agricultural land. The property he is acquiring has tillable land enrolled in the conservation reserve program (CRP) with the balance in timber. Bill agrees to continue the land's enrollment in the CRP and also uses the property for hunting. Even if the hunting use is solely for Bill (i.e., Bill doesn't lease the property for hunting) the exchange still qualifies for tax-deferred status. Bill is deemed to hold the acquired property for investment or business purposes.

<u>NOTE:</u> If property is held for appreciation, the longer it is held the better the case for it qualifying for non-taxable exchange.

E. PERSONAL PROPERTY EXCHANGES:

Personal property is <u>not</u> like-kind with real property. However, personal property assets can be exchanged with other personal property assets that are "like class." A determination as to whether personal property is "like class" is based under the 13 general asset classes listed in Treasury Regulation § 1.1031(a) -2, or alternatively, the North American Industrial and Classification System (NAICS). Some real property transactions include the transfer of associated personal property. In such cases, it may be necessary to complete separate personal property exchange transactions. Examples of personal property asset exchanges include:

- Semi Tractors for Semi Tractors
- Semi Trailers for Semi Trailers
- Road Grader for Road Grader
- Art Work for Art Work
- Restaurant Equipment for Restaurant Equipment
- Computers for Computers

F. RECEIPT OF STOCKS, BONDS, NOTES AND CASH CAUSES BOOT

To qualify for Section 1031 treatment, a taxpayer cannot accept stocks, bonds, notes or cash in return for real property. These types of assets are not exchangeable under Section 1031 and will result in the receipt of boot.

For example, assume a taxpayer exchanges a $100,000 rental house for a $70,000 rental house and $30,000 worth of company stock. Under Section 1031, the $70,000 rental house is like-kind to the $100,000 rental house. However, the $30,000 worth of company stock received is not like-kind to the $100,000 rental house. The taxpayer would pay tax on the receipt of the company stock but would defer taxes on the $70,000 rental house received as like-kind property.

G. DEALER PROPERTIES:

To qualify for Section 1031 treatment, property must be held for investment or for use in a trade or business. Generally speaking, all real property is like-kind to any other type of real property so long as it is held for investment or use in a trade or business. The IRS does not permit Section 1031 treatment of property that is held for sale or as inventory. This is an important distinction.

Persons, who in their ordinary course of business, develop land for resale, or construct buildings or homes for resale, cannot utilize Section 1031. For a developer or contractor, lots and buildings are considered inventory by the IRS and ordinary income taxation rates apply. The same applies for persons who purchase apartment complexes with the intention of selling them to current occupants as condominiums. The primary test is whether or not the exchangor had the intent to hold the property for investment, or for use in a trade or business, at the time the replacement property was acquired. In these instances, the IRS deems the properties to have been acquired for resale. Developers and contractors are not entirely prohibited from using Section 1031, however, the properties that they do exchange must be segregated from their development or contracting businesses.

A more common instance occurs when individuals purchase homes with the intention of updating them and immediately listing them for sale at a profit. These transactions do not qualify for Section 1031 treatment as the properties are held with the intention of selling them, and not for investment purposes. To solve this problem, tax and legal professionals should advise their clients to rent such properties in order to establish an income history. By renting the property or holding it for appreciation, the exchangor will convert the property to a qualifying use, thereby allowing Section 1031 treatment at a later date.

H. CONDEMNED PROPERTIES:

When a taxpayer is considering sale of property to a governmental entity, the taxpayer should consider whether the sale qualifies for I.R.C. Section 1033 treatment instead of Section 1031 treatment. Section 1033 allows relaxed treatment for exchanges out of properties that are to be condemned.

I. MIXED-USE PROPERTIES – THE SALE OF A PERSONAL RESIDENCE AND INVESTMENT PROPERTY

Many farm exchanges involve the sale of land, buildings and a personal residence. Section 121 provides for a gain exclusion ($250,000 or $500,000 for married persons filing jointly) on the sale or exchange of a personal residence if, during the five year period ending on the date of the sale or exchange, the property was owned and used by the taxpayer for an aggregate of two years or more.

When structuring a Section 1031 exchange, tax and legal professionals should split the personal use property from the Section 1031 property. Vacant land can be included in the taxpayer's personal residence so long as it is next to the dwelling unit and was used as a part of the personal residence. The allocation of the house and land constituting the personal residence should maximize, to a reasonable and justifiable degree, the exchangor's utilization of the Section 121 gain exclusion. This becomes important when defining in the exchange agreement what property will be exchanged pursuant to Section 1031. The exchange agreement should only list the property subject to Section 1031 treatment. Tax and legal advisers who prepare exchange agreements may find it useful to attach a map of the property distinguishing the Section 1031 property from the Section 121 property. At settlement, it is best for there to be two closing statements, one for the Section 1031 property and one for the Section 121 property. The preceding principals also apply to the sale of duplexes, apartment buildings, and other mixed-use properties.

As an additional resource, Revenue Procedure 2005-14 provides guidance on the application of Sections 121 and 1031 to an exchange of a single mixed-use property.

J. VACATION "INVESTMENT" PROPERTIES

There are situations where vacation homes clearly do not qualify for Section 1031 treatment. With patience and advanced planning, it is possible to convert a vacation home into an investment property, thus qualifying it for Section 1031 treatment. By renting the vacation home, and discontinuing or substantially reducing personal use, a taxpayer can exchange the property at a later time under Section 1031. A clear and definite history of investment income should be apparent to the I.R.S. in the event of an audit.

In Barry E. Moore et ux. v. Commissioner; T.C. Memo. 2007-134 (May 30, 2007), the tax court held that a taxpayer's vacation homes were not held in a trade or business. Without disqualifying vacation home exchanges, the Court ruled that the taxpayer must show that investment is the primary purpose in holding the vacation property. Neither vacation home was made available for rent and the taxpayers treated all of their interest deductions as home mortgage interest rather than as investment interest. Other evidence presented "overwhelmingly demonstrated that the taxpayers primary purpose in acquiring and holding the homes was to enjoy the use of those properties as vacation home; ie., as secondary, personal residences."

Revenue Procedure 2008-16 provides a safe harbor under which the IRS will not challenge whether a dwelling unit qualifies as property held for investment under Section 1031. A vacation property will qualify for 1031 treatment if the relinquished and/or replacement property is owned for 24 months immediately before or after the exchange, the taxpayer rents the property to another person for fair rental for 14 days or more, and the taxpayer's personal use of the property does not exceed the greater of 14 days or 10 percent of the number of days during the 12 month period during which the property is rented at fair market rental. "Personal use" is defined broadly under the revenue procedure and includes use by family members and other individuals for less than fair market rental, as well as use by an individual who uses the unit under an arrangement which enables the taxpayer to use some other dwelling unit. An exchange may fall outside the safe harbor and still qualify for a 1031 exchange, however, heightened scrutiny would be likely in the event of audit.

K. GUAM, NORTHERN MARIANA ISLANDS AND VIRGIN ISLANDS

U.S. taxpayers can exchange real property located in the United States for real property located in Guam and the Northern Mariana Islands. A U.S. taxpayer is defined as an individual who is a citizen or resident of the United States.

Foreign property cannot be exchanged for U.S. property. However, foreign property can be exchanged for other foreign property. These exchanges can be extremely complex.

U.S. taxpayers can exchange real property located in the United States for real property located in the U.S. Virgin Islands. In the case of an exchange involving the U.S. Virgin Islands, a taxpayer is more strictly defined. A U.S. taxpayer exchanging into a U.S. Virgin Island property is defined as an individual who is a citizen or resident of the United States, and has income derived from sources within the Virgin Islands, or effectively connected with the conduct of trade or business there, or files a joint tax return with an individual who meets those requirements.

L. RETIREMENT PLANNING

A qualifying investment property acquired in a 1031 exchange can be converted to a personal use property. Revenue Procedure 2008-16 provides a safe harbor for vacation home exchange treatment and indirectly addresses the issue converting a principal residence into a qualifying relinquished property prior to an exchange, or converting a replacement property into a personal residence after an exchange. Under Revenue Procedure 2008-16, the I.R.S. will not challenge whether a dwelling unit qualifies as property held for investment under Section 1031 if the relinquished and/or replacement property is owned for 24 months immediately before or after the exchange, the taxpayer rents the property to another person for fair market rental for 14 days or more, and the taxpayer's personal use of the property does not exceed the greater of 14 days or 10% of the number of days during the 12-month period during which the property is rented at fair market rental. Upon satisfying these requirements, a taxpayer can convert the investment property dwelling unit into a personal residence.

Following the conversion of property to a personal use, a taxpayer can at a later date exclude gain on the sale of a personal residence under Section 121 of the Internal Revenue Code. Excludable gain (up to $250,000 per individual and $500,000 per couple) can be taken on a prorata basis for the time the property was used as a personal residence. Nonqualified use prior to January 1, 2009 is not taken into account in the calculation.

To illustrate, assume a taxpayer exchanges into a lakeview condominium and rents the property for two years. After renting the property, the taxpayer converts the condo to her personal residence. After using the property as her personal property for four years, she sells the property for a $300,000 gain. Two-sixths (2 out of 6 years) of the gain, or $100,000, would be ineligible for exclusion. Four-sixths (4 out of 6 years) of the gain, or $200,000, would be eligible for exclusion.

To follow is an example of how Section 1031 can be used as a retirement planning tool:

> Farmer and Mrs. Brown own a 1,000 acre farm. In 2008 they sell 100 acres for $600,000, with $500,000 being subject to capital gains tax. In two years they plan to move to Omaha, Nebraska to be near their grandchildren. Instead of paying tax on the sale of the 100 acres, they exchange into a loft apartment in Omaha. After renting the loft apartment for two years, they move into it as their personal residence. After three years, Farmer and Mrs. Brown decide they want to move to Hot Springs, Arkansas. Under Section 121 of the Internal Revenue Code, Farmer and Mrs. Brown can exclude up to three-fifths of the gain, or $300,000, from the sale.

M. INTEREST IN A PARTNERSHIP DOES NOT QUALIFY FOR EXCHANGE TREATMENT:

An interest in a partnership does not quality for exchange treatment. Partnership interests cannot be exchanged in a 1031 exchange transaction. A typical real property ownership structure involves a limited liability company (LLC) as titleholder to the property, with multiple individuals or entities having joint ownership of the LLC. Multi-member LLCs not taxed as corporations are considered partnerships for federal tax purposes. The partnership itself can sell property and reinvest the proceeds into replacement property in a Section 1031 exchange. However, the individual partners cannot take title to the replacement property in their individual names. This scenario is considered by the I.R.S. as a non-qualifying exchange out of a partnership interest into an individual real property interest. Taxpayers must be careful to avoid this trap and should talk to their tax advisor about the possibility of liquidating the partnership prior to contemplating an exchange.

N. PARTNERSHIP SOLUTIONS:

Partnerships can be informal associations of its members, or as is more commonly the case, an LLC with multiple members. Multi-member LLCs are considered partnerships for federal tax purposes. Members of LLCs seeking to exchange out of the partnership's relinquished property and into replacement properties owned by the members individually must dissolve the partnership and title the property in the names of the individuals as tenants-in-common. This must be done prior to the sale of the relinquished property. It is important to note the cautionary language that follows when considering this strategy.

<u>Partnership Liquidations:</u>

To effectively convert a partnership to a tenancy-in-common (TIC), the following steps must be taken prior to the sale of the relinquished property:

1. Execute and record a deed to transfer all partnership real property to the former partners.
2. Terminate the partnership and any partnership agreement.
3. Assign all leases to the former partners as TIC. Payments to partners.
4. Transfer all assets of partnership to former partners. Notify all creditors of change, close bank accounts.
5. Pay taxes and obligations as individual partners.
6. Purchase and sale agreement in names of formers partners and not in the name of the partnership.
7. Timely file a final partnership tax return.
8. File a protective election under Section 761(a), which allows a partnership to elect out of partnership status.
9. Execute a tenancy-in-common agreement.

Partnership liquidations are not without risk in the event of I.R.S. audit. Although tax courts have ruled favorably upon partnership liquidations when properly structured, the I.R.S. has traditionally taken the position such liquidations followed by an exchange are not permissible. It is important for taxpayers to seek competent tax and legal advice prior to taking this course.

Partnerships Exchange and Contribute:

Another technique for liquidating a partnership involves the partnership selling the relinquished property and exchanging into multiple replacement properties chosen separately by the members of the partnership. After the exchange, the partnership could distribute the individual properties to partners and liquidate the partnership. This is also an aggressive route and should be carefully considered.

As an example, assume JTC, LLC, a partnership between John, Tom and Catherine, owns an apartment complex worth $600,000. John, Tom and Catherine decide they want to go their separate ways once the apartment is sold, however, they each want to avoid the tax consequences and would prefer to exchange into separate replacement properties. As discussed, previously, JTC, LLC cannot sell with John, Tom and Catherine taking title to the new properties individually. An option would be for JTC LLC, to sell the apartment complex and exchange into three separate properties worth $200,000 each. After the exchange is completed the partnership would liquidate and the properties distributed to the partners who chose them.

O. TITLE VESTING:

Although not specifically addressed in the regulations, replacement property must be acquired in the same name as title was held to the relinquished property. It is important to review the title work prior to preparation and execution of exchange documentation and deeding of the replacement property. If property is owned by husband and wife as tenants in common, then the exchange should be carried out in like and similar manner, that is as tenants-in-common. Similarly, if a wife owns property separately from her husband, the replacement property should be titled in the wife’s name only. If desired, a gift of the replacement property can be made later tax free under Section 1041 after the exchange is “old and cold.” In community property states, spouses can take title together as long as the relinquished property is not held as sole and separate property.

Single-member LLCs, not electing to be taxed as a corporation, are disregarded for federal tax purposes. Therefore, an LLC wholly owned by an exchangor, can take title to replacement property even though the relinquished property was titled in the name of the exchangor individually.

P. EXCHANGE BETWEEN RELATED PARTIES:

The related party rules under Section 1031 are complex and their misapplication are commonly a source of failed exchange transactions. Related parties include:

1. Members of a family, such as siblings, spouses, ancestors of lineal descendants.

2. An individual in a corporation of which more than 50% of value of the outstanding stock is owned directly or indirectly by or for such individual.

3. Two corporations part of the same control group.

4. A grantor and a fiduciary of the same trust.

5. A fiduciary and a beneficiary of the same trust.

6. A fiduciary of a trust and a fiduciary, or beneficiary of another trust where the same person is a grantor of both trusts.

7. A fiduciary of a trust in a corporation which more than 50% of the value of the outstanding stock is owned directly, or indirectly, by or for the trust or by or a person who is a grantor of the trust.

8. A corporation and a partnership if the same person owns more than 50% in value of the outstanding stock and more than 50% of the capital interests, or the profits of the partnership.

9. An S corporation and another S corporation in which the same person owns more than 50% in value of the outstanding stock of each corporation.

10. A partnership and a person owning directly, or indirectly, more than 50% of the capital, or profits, interests in the partnership.

11. Two partnerships in which the same person owns directly, or indirectly, more than 50% of the capital, or profits.

12. Executor of an estate and a beneficiary of the estate except in the case of a sale or exchange in satisfaction of a pecuniary bequest.

The most basic form of a related party exchange occurs when two related parties swap properties. As an example, assume two brothers each own an undivided 50% interest in two 80 acre parcels of farmland. Each brother can exchange his 50% interest in order that each may own a 100% interest in one of the parcels. The related party rules permit such an exchange so long as each brother holds the replacement property for two years after the exchange.

Revenue Ruling 2002-83 places additional restrictions on delayed exchanges of properties involving related parties. The ruling generally prohibits an exchangor from purchasing replacement property from a related party when the relinquished property was sold to an unrelated party. The Tax Court applied this reasoning to the disallowance of an exchange in OCMULGEE FIELDS, INC. v. C.I.R., 132 TC 6 (March 31, 2009). Exceptions to this rule include occasions when it can be established to the satisfaction of the I.R.S. that tax avoidance is not the primary motive for the related party transaction. In other words, a basis shift cannot occur.

EXAMPLE: Mary transferred Blackacre to a QI. This was done at a time when Blackacre was worth $150,000, and had a basis of $50,000. It was exchanged for Whiteacre. Whiteacre was owned by Mark, Mary's brother. Whiteacre had an FMV of $150,000 and a basis of $150,000.

Sid, who is unrelated to either Mary or Mark, wants to acquire Blackacre. Sid obtains Blackacre. A few days later, Mark is paid the $150,000 sale price. Mary receives Whiteacre, Sid receives Blackacre, and Mark cashes out of the deal receiving $150,000.

If Mary exchanged directly with Mark, it would have been a related-party exchange, and a sale within two years would have triggered gain on the exchanged property. In this situation, the exchange would have been viewed as an exchange which is part of a transaction (or series of transactions) to avoid the related-party rule and the nonrecognition provisions of IRC §1031 would not apply.

Using Sid (an unrelated third party) to circumvent the related-party rule is ineffective in avoiding the strictures of the related-party provision. Essentially, third party involvement is disregarded. The transaction is viewed as an exchange between Mary and Mark who are related parties, with a sale occurring within the 2-year period specified by the related-party rule.

Eight separate Private Letter Rulings have clarified the position of the I.R.S. as it relates to related party exchange transactions. In PLR 200440002, the I.R.S. stated that a related party deferred exchange will not be disqualified so long as neither party is “cashing out” of their investment. In this PLR, the exchanging partnership (P1) sold its relinquished property to an unrelated party and purchased its replacement property from a related partnership (P2). Had the transaction stopped here, it would run afoul of Revenue Ruling 2002-83. However, after transferring property to P1, P2 conducted its own tax deferred exchange and purchased replacement property from another unrelated party. Both of the related parties executed a deferred like-kind exchange, did not cash out of their investments and agreed to not sell their properties for two years.

In PLR 200706001 related parties executed a simultaneous like-kind exchange to realign each family member’s interest in three parcels so that one of the parties owned 100% of parcel 1. Subsequent to the exchange, the remaining family members owning parcels 2 and 3 sold within the 2 year period. All family members had equal bases in the properties. Because the bases were equal and no basis shift occurred, the I.R.S. ruled that the disposition of parcels 2 and 3 in during the two year holding period would not disallow the exchange.

In PLR 200730002 exchangor sold to a related party and purchased replacement property from an unrelated party. The I.R.S. held that that the related party rules do not apply to a transaction where the related party is the purchaser of exchangor's relinquished property. This is due to the fact that the exchangor is not cashing out of the transaction. In PLR 200712013 the same analysis was carried through in the context of exchangor transferring relinquished property to a related party in a reverse exchange transaction.

Other recent I.R.S. rulings suggest another common scenario should not run afoul of the related party rules. Assume Exchangor sells high basis property to an unrelated party and acquires replacement property from a related party with a basis that is lower than exchangors. At first glance it appears that this transaction runs afoul of Revenue Ruling 2002-83 since exchangor is acquiring replacement property from a related party. However, in the present case, the related party will be paying more tax to the government than exchangor would, had exchangor cashed out of the investment without doing an exchange. Although a basis shift occurs, it is to the detriment of the related party.

Q. PRE AND POST EXCHANGE FINANCING:

To avoid all taxable gain, the replacement property must have debt, equity, and a fair market value that is greater than or equal to that of the relinquished property. If an exchangor takes cash from an exchange ("boot"), there will be tax on the cash received.

If an exchangor desires to take equity or cash from a property without paying tax, current case law supports the proposition that an exchangor can encumber the relinquished property before an exchange or replacement property after an exchange. Despite the favorable case law, it should be noted that the I.R.S. does not support the proposition that equity can be taken from relinquished property in anticipation of an exchange or from replacement property immediately following the exchange. The I.R.S does not disapprove of pre-exchange financing if it occurs in advance of a taxpayer's contemplation of an exchange, and not in anticipation of it. This is especially true if the refinancing has an independent economic significance from the exchange.

Utilizing this strategy does have some tax risk and exchangors should approach this technique cautiously.

R. EARLY RELEASE OF EXCHANGE ACCOUNT FUNDS:

Section 1031 restricts an exchangor's right to receive, pledge, borrow, or otherwise obtain the benefits of money or other property before the end of the exchange period. There are a number of circumstances where an exchangor may want to receive some, all, or remaining proceeds from the exchange account prior to the end of the 180-day exchange period.

Under the I.R.S. Regulations, the exchangor cannot receive funds held by the qualified intermediary until the occurrence of one of three events. The first event is when the 45-day identification period has expired and no identification was made (or property identification was revoked before the 45th day). The second is when the exchangor identifies property within the 45 days and closes on all identified properties. The third is when the 180-day exchange period has expired.

The position of the I.R.S. is clear that if funds are released from the qualified intermediary account prior to the occurrence of one of the three above instances, the exchange will fail. Recent tax court cases support the I.R.S.'s position.

As an example, assume taxpayer sells relinquished property for a price of $500,000, all of it being equity. Prior to Day 45, Taxpayer timely identifies six properties under the 200% Rule. On Day 60, Taxpayer acquires a replacement property worth $200,000 located in Florida. On Day 90, Taxpayer acquires his second replacement property worth $200,000. On Day 100, Taxpayer contacts the qualified intermediary demanding that the remaining $100,000 proceeds due to the fact that the sunroom of the Florida property suffered major water damage as a result of a hurricane.

The first opportunity to release exchange funds occurs when the 45-day identification deadline passes and no identification has been made. In the present example, releasing funds is not possible. The second occasion to release funds occurs when all identified properties have been acquired. In this example, six properties were identified and only two were acquired. As a result, the remaining $100,000 can be released only on Day 181. Early release of exchange funds in this example would taint the exchange. This is a common error on the part of inexperienced and underqualified intermediaries.

VII. THE QUALIFIED INTERMEDIARY REQUIREMENT

A. DESIGNATION OF A QUALIFIED INTERMEDIARY

If closing occurs on either the sale of the relinquished property or the purchase of the replacement property without qualified intermediary documentation in place, the transaction will fail. Similarly, if the taxpayer, a disqualified party or an agent of the taxpayer receives the exchange proceeds at closing the transaction will fail. The previous points cannot be overemphasized. A taxpayer cannot simply hold funds in escrow after closing and then execute appropriate documentation.

B. ROLE OF THE QUALIFIED INTERMEDIARY

Taxpayers who utilize the tax deferral provisions of Section 1031 should use the services of a qualified intermediary to accommodate the transaction and hold proceeds in trust. The qualified intermediary requirement results from I.R.S. regulations detailing the form and structure of an exchange transaction. The qualified intermediary must be a disinterested third party and cannot include any agent of the taxpayer who served in such a capacity within the two years prior to the ensuing exchange transaction. Examples of disqualified parties include the taxpayer's attorney, accountant, real estate agent/broker, investment advisor/broke, or employee. Certain family members and certain corporate entities related to the taxpayer are excluded as well. Under the Internal Revenue Code's attribution rules in 267(b) and 707(b), the disqualification cannot be avoided by setting up a separate legal entity owned by the disqualified party, certain partners of the disqualified party or by a disqualified party's family member.

Advanced planning is the key to a successful exchange transaction. It is crucial that a taxpayer retain the services of a qualified intermediary company prior to closing, and preferably before entering into a purchase agreement.

Of primary importance is the ability of the qualified intermediary to identify potential problems that would disqualify a transaction or necessitate an alternative structure. Similarly, the qualified intermediary should serve as a leading resource to the taxpayer and his/her real estate, tax, legal and other advisors.

Of equal importance is the documentation service provided by the qualified intermediary. Documents should include the 1031 cooperation addendum, Exchange Agreement, proper assignments of the real estate contracts and notices of the assignments, closing instructions, identification notices and documents, exchange account documents and appropriate replacement property documentation.

C. CHOOSING THE QUALIFIED INTERMEDIARY

Qualified intermediary companies provide varying levels of service, expertise and security. Taxpayers should conduct careful inquiry into the background and qualifications of the principals of the company. Of the states that regulate the qualified intermediary industry, requirements include:

- Business operations must be conducted under the direct management of a licensed attorney, CPA, Certified Exchange Specialist or other person with at least three years experience as an exchange facilitator.

- Error and Omissions insurance of not less than $250,000.

- Fidelity bond of not less than $1,000,000.

- Specific safety controls for release of exchange funds.

- Other factors taxpayers should consider when choosing a qualified intermediary include availability of the following:

- Documentation and monitoring in strict compliance with I.R.S. regulations.

- Separate exchange accounts for each exchange transaction (no pooling of exchangors' funds or commingling with the qualified intermediary's operating accounts).

- Monthly account statements directly from the bank to the exchangor.

- Option of custodial trust account arrangements with the bank.

- Option of dual signature requirements for release of funds.

- Option of private insurance for exchange accounts with balances in excess of the FDIC insurance limit.

- Supervision and review of company financial records and exchange account reconciliations by outside CPA and accounting professionals.

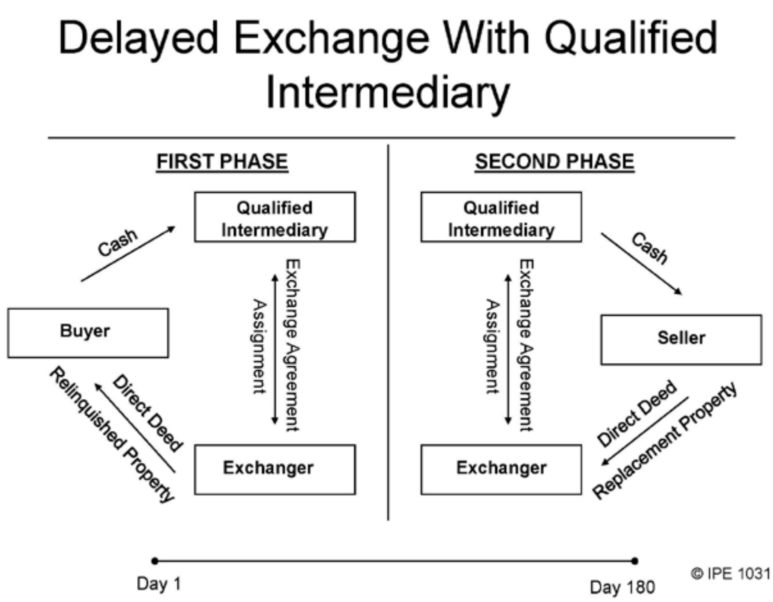
- Membership in good standing with the Federation of Exchange Accommodators (FEA), the only trade organization and governing body for the qualified intermediary industry.

On August 27, 2008, the Treasury Inspector General for Tax Administration issued its final report after conducting an audit of the Qualified Intermediary Industry. "Guidance Could Be Enhanced for Deciding to Use a Qualified Intermediary in Like-Kind Exchanges," Treasury Inspector General for Tax Administration, Reference Number: 2008-30-154 (August 27, 2008) ("Report"). The Report states: "Our review of the tax rules, analysis of statistical information, and discussions with attorneys from the IRS Office of Chief Counsel and representatives from the Federation of Exchange Accommodators (FEA) highlights the critical role qualified intermediaries play in a like-kind exchange." Report, p. 3. The Report further explains, "Besides restricting access to assets during the exchange period, qualified intermediaries are popular because, as our research indicated, they can assist in properly structuring and facilitating the transaction to comply with the related tax rules governing like-kind exchanges." Report, p. 3.

However, the Report cautions taxpayers stating: "Qualified intermediaries are not licensed or regulated and have minimal Federal Government oversight. In addition, they are not subject to minimum standards for training, competency, or conduct, and they operate in a variety of business entities ranging from large professional financial service entities and enterprises to individuals with little or no formal training. In short, almost anyone can offer qualified intermediary services." Report, p. 4.

As the foregoing suggests, taxpayers should exercise extreme care when choosing a qualified intermediary.

D. DELAYED EXCHANGE WITH A QUALIFIED INTERMEDIARY



The flow chart above demonstrates a delayed exchange using a qualified intermediary. Phase one occurs when the relinquished property is sold by the taxpayer (exchangor) to the buyer. At or before closing, the exchangor enters into appropriate documents with the qualified intermediary. At closing, and as a result of the real estate contract having been assigned from the exchangor to the qualified intermediary, the exchangor deeds the relinquished property directly to the buyer without title passing through the qualified intermediary. The closing agent then forwards the proceeds of the sale directly to the qualified intermediary. Exchange deadlines start from the date of the relinquished property closing.

Phase two occurs at the closing of the replacement property, and only if the Exchangor has identified replacement property to the qualified intermediary in a timely matter. Identification requirements will be discussed in the next section. As before, the replacement property purchase agreement is assigned to the qualified intermediary and the Exchange Agreement remains in force. At closing, the property is deeded directly from the replacement property seller to the exchangor. The qualified intermediary then distributes the cash from the exchange account to the replacement property seller. Phase two must occur within 180 days from the closing of the relinquished property.

VIII. DOCUMENTING THE EXCHANGE

A. PURCHASE AGREEMENT COOPERATION LANGAUGE (RELINQUISHED PROPERTY):

Purchase and sale agreements should contain language securing the non-exchanging party's obligation to cooperate with a Section 1031 exchange. The language can be placed directly within the body of the agreement or the contract can be amended using a separate form. An example of cooperation language for the relinquished property follows:

> It is the intention of Seller to transfer the above-listed property pursuant to Internal Revenue Code Section 1031, which sets forth the requirements for tax-deferred real estate exchanges. Seller's rights under this and future agreements may be assigned to a qualified intermediary for the purpose of completing an exchange. Buyer agrees to cooperate with Seller in a manner necessary to enable Seller to complete an exchange. Such cooperation shall be at no additional cost or liability to Buyer.

Optional language may also be included to make the sale contingent upon the taxpayer's ability to locate replacement property suitable for the exchange. An example of the contingency language follows:

> The Purchase and Sale Agreement is contingent upon Seller's ability to accomplish a tax-deferred exchange. In selling the property subject to this Agreement, should Seller be unable to accomplish a tax-deferred exchange, Seller shall be authorized to cancel this sales contract, in writing, on or before the ___ day of _________, 20__, without further liability to Seller or Broker.

B. EXCHANGE AGREEMENT:

The Exchange Agreement is the formal contract between the taxpayer and the qualified intermediary. This document is required under I.R.S. regulations. Of central importance to this is the requirement that the contractual language expressly prohibits the taxpayer to have any right to "receive, pledge, borrow, or otherwise obtain the benefits" of the exchange funds on deposit with the qualified intermediary. In addition, the Exchange Agreement details the method in which exchange funds are to be accounted for and invested, time limitations and identification procedures and it contains a general description of the intent of the parties. If the Exchange Agreement is not signed prior to or at the closing of the relinquished property, the exchange will fail.

C. ASSIGNMENT AND NOTICE (RELINQUISHED PROPERTY):

Under the qualified intermediary safe-harbor, the purchase and sale agreement must be assigned to the entity serving as qualified intermediary. It is crucial the purchase agreement not prohibit assignments to other parties. The purchase agreement addendum should amend the terms of the purchase agreement to allow assignment to a qualified intermediary.

Section 1031 also requires that notice of the assignment be provided to all parties to the agreement. This is typically accomplished by having the non-exchanging buyer or seller acknowledge their receipt of the notice. The I.R.S. holds the position that if notice of the assignment is not provided, the exchange will fall outside of the safe-harbor and is at risk of being disallowed. All parties to the agreement must receive notice and it is not sufficient to provide notice to his/her agent.

An example of the Assignment and Notice for the relinquished property follows:

ASSIGNMENT OF RESIDENTIAL SALES CONTRACT
(Relinquished Property)

This Assignment is entered into by and between EXCHANGER ("Exchanger") and ____________________ ________________________________ ("Intermediary").

Exchanger, as Seller, entered into that certain Residential Sales Contract with BUYER ("Buyer"). The agreement, together with any and all amendments thereof (collectively the "Agreement"), is incorporated herein by reference.

Exchanger and Intermediary have executed an Exchange Agreement in which Exchanger has agreed to transfer the subject property of the Agreement ("Relinquished Property") to Intermediary, in consideration of Intermediary's acquisition of suitable replacement property to Exchanger. Intermediary agrees to assume Exchanger's benefits under this Agreement.

NOW, THEREFORE, the parties agree:

1. Exchanger hereby assigns its rights in the Agreement to Intermediary. All representations and warranties in the Agreement shall survive this Assignment to Intermediary. Intermediary hereby accepts Exchanger's rights.

2. Intermediary hereby requests and directs Exchanger to deed the Relinquished Property directly to Buyer.

IN WITNESS WHEREOF, the parties have executed this agreement as their free and voluntary act and deed, on the date indicated by each signature.

EXCHANGER: INTERMEDIARY:

________________________________ ____

EXCHANGER Date Date

NOTICE OF ASSIGNMENT OF RESIDENTIAL SALES CONTRACT
(Relinquished Property)

TO: SELLER, and/or assigns,

You are hereby notified that EXCHANGER ("Exchanger"), under the Assignment of Residential Sales Contract as set forth above, has assigned to the undersigned Intermediary, Exchanger's rights and benefits under the Agreement and the undersigned, as Intermediary, has accepted the assignment.

ACKNOWLEDGED:

____

SELLER Date

THIS NOTIFICATION MUST BE DELIVERED TO THE BUYER PRIOR TO OR AT CLOSING

D. CLOSING INSTRUCTIONS (RELINQUISHED PROPERTY):

Once the initial exchange documents have been signed by the exchangor and the qualified intermediary and the exchange account has been opened, the qualified intermediary works with the closing agent to ensure all exchange requirements have been met. Closing instructions typically request that prior to closing, the settlement agent provide the title commitment/opinion, proposed settlement statement, proposed deed and a signed copy of the 1031 closing instruction letter.

E. REPLACEMENT PROPERTY NOTICES:

After closing the relinquished property sale, the qualified intermediary will send a letter to the taxpayer containing information about the next steps in the exchange process. Within the letter is a statement as to the amount of exchange funds received and a statement of the important exchange deadlines and procedures. Identification letters also may.be included.

F. REPLACEMENT PROPERTY COOPERATION LANGUAGE:

As with the relinquished property purchase agreement, the purchase and sale agreement for the replacement property must be assigned to the entity serving as qualified intermediary. It is crucial the purchase agreement not prohibit assignments to other parties. The purchase agreement addendum should amend the terms of the purchase agreement to allow assignment to a qualified intermediary.

Occasionally, a property seller will use the 1031 exchange time restrictions as negotiation leverage against the taxpayer. This occurs when the seller is notified that the taxpayer is utilizing an exchange, the seller's property has been identified, seller is aware taxpayer's 45-day deadline has passed and no purchase agreement has been executed. To avoid this occurrence, it may be advisable for the taxpayer and/or taxpayer's agent to not disclose the fact of the 1031 exchange. Once the major terms of the purchase agreement have been negotiated, the 1031 cooperation clause can be inserted into the purchase agreement as an addendum or amendment.

Sample cooperation language for the replacement property purchase agreement follows:

> It is the intention of Buyer to purchase the above-listed property pursuant to Internal Revenue Code Section 1031, which sets forth the requirements for tax-deferred real estate exchanges. Buyer's rights under this purchase agreement have been assigned to IPE 1031, Qualified Intermediary, for the purpose of completing such exchange. Seller of the above-listed property agrees to cooperate with Buyer and IPE 1031, in a manner necessary to enable Buyer to complete said exchange. Such cooperation shall be at no additional cost or liability to Seller.

Optional Language:

> The sales contract is contingent upon Seller's ability to accomplish a tax-deferred exchange. Buyer shall have the right under this Agreement to cancel said Agreement should Buyer be unable to successfully transfer Buyer's relinquished property, described as: _______________________, prior to closing.

G. CLOSING INSTRUCTIONS (REPLACEMENT PROPERTY):

As with the relinquished property closing, prior to closing of the replacement property, the qualified intermediary will forward closing instructions to the settlement agent. Contained within the instructions is a request for the proposed deed, title opinion or commitment, proposed settlement statement and a signature acknowledgment from the settlement agent agreeing to administer the instructions as requested by the qualified intermediary. These pre-closing documents are requested to ensure the exchange documents have been accurately drafted. Specifically, the deed and title opinion confirm that the appropriate parties have been identified and the legal description is correct. The settlement statement is reviewed by the qualified intermediary to ensure it reflects the intent of the exchanging party to utilize Section 1031 and to be sure non-exchange expenses that can cause a taxable event are not listed on the statement. Finally, by signing the closing instructions, the settlement agent agrees to disburse funds in accordance with I.R.S. regulations.

H. ASSIGNMENT OF PURCHASE AGREEMENT (REPLACEMENT PROPERTY):

As mentioned in the context of the relinquished property, Section 1031 also requires that notice of the assignment be provided to all parties to the agreement. This is typically accomplished by having the non-exchanging parties acknowledge their receipt of the notice. The I.R.S. holds the position that if notice of the assignment is not provided, the exchange will fall outside of the safe-harbor and is at risk of being disallowed. Every party of the agreement must receive notice and it is not sufficient to provide notice to his/her agent.

An example of the relinquished property Assignment and Notice form follows:

ASSIGNMENT OF PURCHASE AND SALE AGREEMENT
(Replacement Property)

This Assignment is entered into by and between EXCHANGER L.L.C. ("Exchanger") and ______________ ______________________________ ("Intermediary").

Exchanger, as Buyer, entered into that certain Purchase and Sale Agreement with SELLER ("Seller"). The Agreement, together with any and all amendments thereof (collectively the "Agreement"), is incorporated herein by reference.

Exchanger and Intermediary have executed an Exchange Agreement in which Intermediary has agreed to acquire the subject property of the Agreement (the "Replacement Property") and to transfer it to Exchanger, in consideration of Exchanger's transfer of certain other property to Intermediary. Intermediary agrees to assume Exchanger's rights under this Agreement.

NOW, THEREFORE, the parties agree:

1. Exchanger hereby assigns its rights in the Agreement to Intermediary. All representations and warranties in the Agreement shall survive this Assignment to Intermediary. Intermediary hereby accepts Exchanger's rights.

2. Intermediary hereby requests and directs Seller to deed the Replacement Property directly to Exchanger.

IN WITNESS WHEREOF, the parties have executed this agreement as their free and voluntary act and deed, on the date indicated by each signature.

EXCHANGER:	INTERMEDIARY:
EXCHANGER L.L.C.	
By: ______________________________	______________________________
EXCHANGER Date	Date

NOTICE OF ASSIGNMENT OF PURCHASE AND SALE AGREEMENT

TO: SELLER, and/or assigns

You are hereby notified that EXCHANGER ("Exchanger") under the Assignment of Purchase and Sale Agreement as set forth above, and pursuant to Internal Revenue Code Section 1031, have assigned to the undersigned Intermediary, Exchanger's rights and benefits under the Agreement and the undersigned, as Intermediary, has accepted the assignment.

ACKNOWLEDGED:

____
SELLER Date

THIS NOTIFICATION MUST BE DELIVERED TO THE SELLER PRIOR TO OR AT CLOSING

I. FORM 8824 TO REPORT EXCHANGE:

Taxpayers who complete a section 1031 exchange must report its occurrence to the IRS at the time they file their tax return for the year during which the relinquished property was sold. Form 8824 is used to report the exchange transaction.

An example of Form 8824 follows:

Form **8824**

Department of the Treasury
Internal Revenue Service

Like-Kind Exchanges

(and section 1043 conflict-of-interest sales)

▶ Attach to your tax return.

OMB No. 1545-1190

2012

Attachment Sequence No. **109**

Name(s) shown on tax return	Identifying number
xxxxx zzz	123-45-6789

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:

45 Acre Farm Real Estate Improved

2 Description of like-kind property received:

80 Acre Farm Unimproved

3	Date like-kind property given up was originally acquired (month, day, year)	3	7/10/12
4	Date you actually transferred your property to other party (month, day, year)	4	9/1/12
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	10/12/12
6	**Date you actually received the like-kind property from other party (month, day, year). See instructions**	6	12/31/12

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**

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 or transfer property into the exchange, directly or indirectly (such as through an intermediary), that became your replacement property? . . . . ☐ 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** (2012)

Name(s) shown on tax return. Do not enter name and social security number if shown on other side.
xxxxx zzz

Your social security number
123-45-6789

Part III Realized Gain or (Loss), Recognized Gain, and Basis of Like-Kind Property Received

Caution: *If you transferred **and** received **(a)** more than one group of like-kind properties or **(b)** cash or other (not like-kind) property, see **Reporting of multi-asset exchanges** in the instructions.*

Note: *Complete lines 12 through 14 **only** if you gave up property that was not like-kind. Otherwise, go to line 15.*

12	Fair market value (FMV) of other property given up	12	170,000		
13	Adjusted basis of other property given up	13	0		
14	Gain or (loss) recognized on other property given up. Subtract line 13 from line 12. Report the gain or (loss) in the same manner as if the exchange had been a sale			14	170,000
	Caution: *If the property given up was used previously or partly as a home, see* **Property used as home** *in the instructions.*				
15	Cash received, FMV of other property received, plus net liabilities assumed by other party, reduced (but not below zero) by any exchange expenses you incurred (see instructions)			15	
16	FMV of like-kind property you received			16	400,000
17	Add lines 15 and 16			17	400,000
18	Adjusted basis of like-kind property you gave up, net amounts paid to other party, plus any exchange expenses **not** used on line 15 (see instructions)			18	51,455
19	**Realized gain or (loss).** Subtract line 18 from line 17			19	348,545
20	Enter the smaller of line 15 or line 19, but not less than zero			20	0
21	Ordinary income under recapture rules. Enter here and on Form 4797, line 16 (see instructions)			21	170,000
22	Subtract line 21 from line 20. If zero or less, enter -0-. If more than zero, enter here and on Schedule D or Form 4797, unless the installment method applies (see instructions)			22	0
23	**Recognized gain.** Add lines 21 and 22			23	170,000
24	Deferred gain or (loss). Subtract line 23 from line 19. If a related party exchange, see instructions			24	178,545
25	**Basis of like-kind property received.** Subtract line 15 from the sum of lines 18 and 23			25	221,455

Part IV Deferral of Gain From Section 1043 Conflict-of-Interest Sales

Note: *This part is to be used **only** by officers or employees of the executive branch of the Federal Government or judicial officers of the Federal Government (including certain spouses, minor or dependent children, and trustees as described in section 1043) for reporting nonrecognition of gain under section 1043 on the sale of property to comply with the conflict-of-interest requirements. This part can be used **only** if the cost of the replacement property is more than the basis of the divested property.*

26 Enter the number from the upper right corner of your certificate of divestiture. (**Do not** attach a copy of your certificate. Keep the certificate with your records.) ▶ –

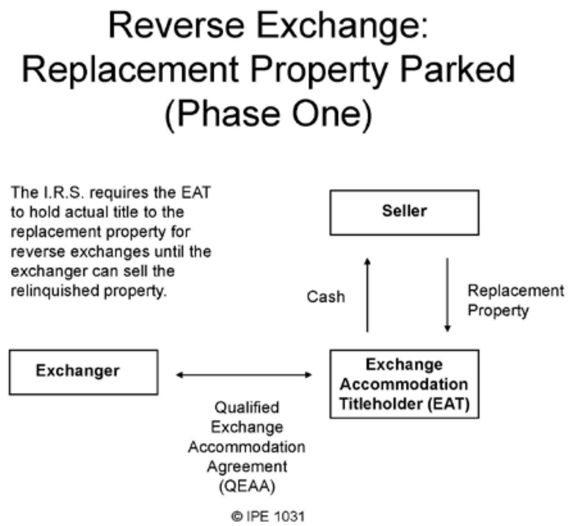
27 Description of divested property ▶

28 Description of replacement property ▶

29	Date divested property was sold (month, day, year)			29	MM/DD/YYYY
30	Sales price of divested property (see instructions)	30			
31	Basis of divested property	31			
32	**Realized gain.** Subtract line 31 from line 30			32	
33	Cost of replacement property purchased within 60 days after date of sale	33			
34	Subtract line 33 from line 30. If zero or less, enter -0-			34	
35	Ordinary income under recapture rules. Enter here and on Form 4797, line 10 (see instructions)			35	
36	Subtract line 35 from line 34. If zero or less, enter -0-. If more than zero, enter here and on Schedule D or Form 4797 (see instructions)			36	
37	**Deferred gain.** Subtract the sum of lines 35 and 36 from line 32			37	
38	**Basis of replacement property.** Subtract line 37 from line 33			38	

IX. THE REVERSE EXCHANGE

A. REVERSE EXCHANGE PHASE ONE - PARKING THE PROPERTY:



A reverse exchange may be better described as a "parking transaction" due to the fact that what actually occurs is that a parking entity is established to hold title to the taxpayer's replacement property until the relinquished property can be sold. This is the first phase of a reverse exchange. As the flow chart indicates, through a series of documentation events, cash is loaned from the exchangor to the Exchange Accommodation Titleholder (EAT). The EAT uses the cash to acquire the replacement property from the seller of the replacement property. The EAT holds the property until the relinquished property can be sold, at which time the EAT sells the parked property back to the exchangor in return for the exchange proceeds from the sale of the relinquished property. Once in receipt of the exchange proceeds, the EAT uses those funds to pay the loan owed to the exchangor.

B. EXCHANGE ACCOMMODATION TITLEHOLDER REQUIREMENT:

Revenue Procedure 2000-37 provides a safe-harbor procedure for taxpayers seeking to execute a reverse exchange transaction. Prior to this guidance, it was thought almost impossible to accomplish an exchange if one did not first sell the relinquished property prior to acquiring the replacement property.

Under the Revenue Procedure, to begin a reverse exchange, the taxpayer must choose a qualified intermediary company that is willing to serve as EAT. In some cases, taxpayers may desire to have an individual serve as EAT, outside of the I.R.S. safe harbor. This is not advisable as it is possible that the taxpayer's property could be subject to attachment in bankruptcy or divorce proceeding, or in the alternative, the individual could initiate actions related to the property that are adverse to the interest of the taxpayer. As with the qualified intermediary requirement, an EAT must be a disinterested third party and cannot include any agent of the taxpayer who served in such a capacity within the two years prior to the ensuing exchange transaction. Examples of disqualified parties include the taxpayer's attorney, accountant, real estate agent/broker, investment advisor/broker or employee. Certain family members and certain corporate entities related to the taxpayer are excluded as well.

Proper and customary practice is for the EAT to form a single-purpose LLC for the purpose of holding the taxpayer's property. This technique insulates the taxpayer's property from other assets and creditors of the EAT. At the conclusion of the exchange, the EAT LLC is dissolved. The regulations require that the EAT be a taxable entity and that a tax return be prepared by the EAT to report the transaction. Some states prohibit corporation ownership of farmland and an EAT LLC holding title to farmland would be in violation of its laws. When considering a reverse exchange transaction, the taxpayer or his advisors should review applicable state law to ensure such violations do not occur.

C. EXCHANGE ACCOMMODATION TITLEHOLDER PROCEDURES:

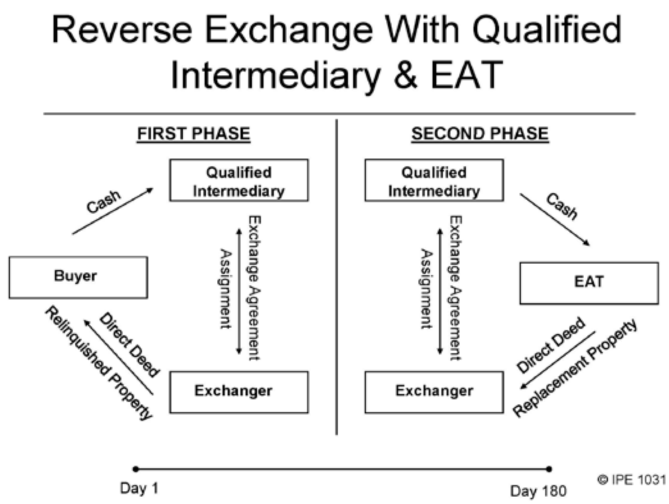
Once the EAT LLC is formed, a formal document designating the EAT is signed by the taxpayer and the EAT. The taxpayer advances the funds to the EAT. If a loan from a financial institution is required to obtain funds for the purchase by the EAT, the loan may be made to the EAT and it should be guaranteed by the exchangor. The loan should be secured by appropriate lien documents against the property held by the EAT. The EAT uses these funds to purchase the "property to be acquired." Title must be taken in the name of the EAT, not the taxpayer. The deed is recorded. Insurance on the property should be endorsed over to the EAT. After acquisition of the property by the EAT, the EAT should lease the property, typically on a triple-net basis, to the exchangor for the term of the parking period.

Once title is taken, within five business days, the "Qualified Exchange Accommodation Agreement" must be entered into. This is the same as the exchange agreement if one was doing a regular delayed exchange. Good practice would dictate executing the agreement before the settlement date. Depending on the form of the reverse exchange, it may also be necessary to execute a deferred exchange utilizing a qualified intermediary.

Within 45 days of receipt of the title of the "property to be acquired," identification of the property to be sold must be made. This is usually not a problem since the taxpayer had this in mind since the inception.

Within 180 days of when the EAT acquires the property, the relinquished property must be sold and the EAT must transfer the property it is holding to the taxpayer.

D. REPLACEMENT PROPERTY PARKED (PHASE TWO):



Phase two of the reverse exchange transaction begins when the relinquished property is sold by the taxpayer. Just as with a delayed exchange, a qualified intermediary is retained by the taxpayer to accommodate the sale of the relinquished property. Typically, the qualified intermediary is the same company that owns the EAT. The main difference is that instead of the taxpayer purchasing the replacement property from the original seller, the property is purchased from the EAT. Proceeds from the sale of the relinquished property are transferred from the qualified intermediary to the EAT at which time the EAT deeds the property to the taxpayer. The EAT then uses the relinquished property proceeds to pay the loan the taxpayer made to the EAT.

After the exchange is completed, the EAT dissolves the LLC. It is also crucial that the EAT file a tax return to report the purchase and sale of the parked property.

E. REVERSE EXCHANGE AVOIDANCE:

Reverse exchange transactions are time intensive and complicated. As a result, and due to liabilities assumed by the EAT by being in the chain of title, fees for structuring a transaction are significantly more than fees for a delayed exchange. It is common that the reverse exchange fee is well worth the expense in light of the potential tax obligation. However, in some cases, the fee may outweigh the potential tax savings. As a result, it may be prudent to explore other options to delay closing of the replacement property.

Options for delaying closing include offering additional earnest money to the seller, entering into an option agreement, entering into a rental agreement or paying interest to the seller for exchange funds not received on the date of closing. Taxpayers utilizing these options must be careful to ensure that an actual transfer does not appear to have occurred. The more it appears the "benefits and burdens of ownership" have been transferred, the more likely the exchange will be disallowed. It is additionally important to avoid the common mistake of offering concessions to delay closing that exceed the cost of the reverse exchange.

F. CONSTRUCTING IMPROVEMENTS ON REPLACEMENT PROPERTY:

In order for improvements on a replacement property to qualify as property that is like-kind to the relinquished real property, they must be completed at the time the property is transferred to the taxpayer. Improvements constructed on the property after the taxpayer takes title do not qualify.

As an example, improvements may be appropriate when a taxpayer sells relinquished property for $500,000 and identifies replacement property comprised of bare land valued at $200,000. As discussed earlier in the course, in order to defer all tax on the sale of the relinquished property, the replacement property value when title is taken must be $500,000. In order to reach this level, $300,000 worth of improvements need to be completed on the bare ground prior to the taxpayer's acquisition.

One option to satisfy this requirement is to have the improvements constructed by the seller prior to the transfer to the taxpayer. The purchase agreement for the property would include the value of the underlying real estate plus the costs associated with the improvements.

Another option is to have a developer or contractor take title to the property while the improvements are being constructed. Once the improvements are constructed the accommodating developer or contractor will sell the land and improvements to the taxpayer.

The more common occurrence is to have an Exchange Accommodation Titleholder take title to the property and construct the improvements on behalf of the taxpayer. Ordinarily the proceeds from the sale of the relinquished property as used to pay for the improvements with additional funds coming from the taxpayer.

****

X. FORMS

Forms included in previous versions of the ISBA Tax Manual are no longer included. Two leading 1031 legal treatises provide updated and detailed 1031 exchange forms and instructions. Practitioners who structure 1031 exchange transactions are encouraged to consult the following resources:

Jeremiah M. Long & Mary B. Foster, Tax-Free Exchanges Under § 1031 (West 2012).

Louis S. Weller & Cecily A. Drucker, Real Property Exchanges (3d ed., The Regents of the University of California 2012).

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XI. EXAMPLES/PROBLEMS

EXAMPLE: Siblings Barb, Bill, and Betty each inherit a 1/3 undivided interest in three properties of equal value. In a partition, Barb, Bill, and Betty each exchange their 1/3 interest in each property for a 100% interest in one of the three properties. The transaction qualifies as a tax-deferred exchange and can be structured using a QI, or as a multiparty exchange, or a circular exchange.

EXAMPLE: In an exchange of improved for unimproved land in which part of all of the improvements are IRC §1245 property, the exchange is likely to lead to recapture consequences for the transferor of the improved property.

Tom entered into a like-kind exchange. He traded his §1245 property, with an adjusted basis of $100,000, for a like-kind property with a FMV of $90,000 and an unlike-kind property with an FMV of $35,000. Upon the exchange, $25,000 (($90,000 + $35,000) - $100,000) of gain is recognized because the property worth $35,000 is not IRC §1245 property. The basis of the properties received in the exchange is $125,000 ($100,000 + $25,000). Of that amount, $35,000 is allocated to the property worth $35,000, and the $90,000 balance is allocated to the other property.

In some cases, depreciable real property (other than IRC §1245 property – e.g. machine shed, barn, shop, etc.) is transferred in a like-kind exchange. The amount of gain taken into account as recapture income is the larger of:

- The gain recognized on the exchange; **or**
- The excess, if any, of the gain reported as ordinary income because of additional depreciation had the property been sold **less** the FMV of the IRC §1250 property acquired in the transaction.

EXAMPLE: On September 1,2010, Mike exchanged his fee interest in a 45-acre tract of farm real estate with improvements (FMV of $400,000) for a fee interest in an 80-acre tract of bare farm real estate (FMV of $400,000). Mike intended the transaction to be a like-kind exchange. What is the tax consequence of Mike's exchange?

Like-Kind Property	FMV	Basis	Gain Realized
Land (40 Acres)	$185,000	$32,000	$153,000
Tile (40 acres)	15,000	0	15,000
Land/acreage (5 acres)	10,000	2,500	7,500
Machine shed (2002)	20,000	16,955	3,045
TOTAL	$230,000	$51,455	$178,545

Unlike-Kind Property IRC §1245 Recapture	FMV	Basis	Gain Realized
Well/water system	$ 3,500	$ 0	$ 3,500
Machine shed (1985) accel. depr. (not SL)	6,500	0	6,500
Hog confinement bldg.	125,000	0	125,000
Grain bins/drying system	35,000	0	35,000
TOTAL	$170,000	$ 0	$170,000

Fair market value	$400,000
Basis	(51,455)
Gain realized	$348,545
Gain recognized (§1245 recapture)	(170,000)
Gain deferred	$178,545

For IRC §1250 property, recapture is recognized to be the larger of:

1. The excess, if any, of the gain reported as ordinary income due to additional (post-1969) depreciation had the property been sold, **less** the FMV of the IRC §1250 property acquired in the exchange; **or**

2. Any gain on the exchange, regardless of the recapture provision. IRC §1250(d)(4).

The recapture of depreciation is partially or fully deferred until there is a disposition of the acquired property. The basis of the property received is the basis of the exchanged IRC § 1250 property:

- **Decreased** by the amount of any money received that was not spent acquiring similar property,
- **Increased** by the amount of gain recognized, and
- **Decreased** by the amount of loss recognized. If more than one item of property of each type is received, the total basis is allocated to the individual items of property.

> **Note.** The Form 8824 instructions set forth the above rules and provide a location on the form for calculating the recapture amounts under both IRC §1245 or §1250.

The recapture for IRC §1250 property is deferred until disposition of the acquired property. For real property, gain is recognized as recapture income in the exchange of like-kind assets to the extent that the amount of recapturable income exceeds the FMV of the acquired depreciable real property. If gain is recognized on the exchange, recapture income is recognized to the extent of the greater of the gain recognized under the like-kind rules, or the amount of recapture income less the FMV of the acquired depreciable real property.

APPENDIX

XII. TAX UPDATE*

A. 2012 Update

Related Party Issues

1. **Private Letter Ruling 201216007:** Non-tax avoidance exception to 1031(f)(4) applies when related parties are also exchanging and receive limited amount of boot.

2. **Private Letter Ruling 2012120012 (5/18/2012):** Related party series exchanges each have their own identification and replacement periods.

Qualified Use Issues

3. **Patrick A. Reesink et ux. V. commissioner; T.S. Memo 2012-118**: qualified use of residence.

Other Matters

4. **Proposed Regs Address Section 1031 in a RIC or REIT Conversion Transaction:** The IRS has issued proposed regulations also providing that RIC or REIT will not be subject to the built-in gain tax to the extent that the transfer by the C corporation qualifies for nonrecognition treatment under IRC § 1031 or §1033. (Prop Reg § 1.337(d)-7(d)(3)).

B. 2011 Update

1. **Private Letter Ruling 201048025:** Non-tax avoidance exception to 1031(f)(4) applies when related parties are also exchanging.

2. **Peter Morton v. US:** No constructive receipt when escrow agent erroneously disburses funds to taxpayer and taxpayer returns them.

C. 2010 Update

1. **Teruya Brothers, Ltd. & Subsidiaries, (CA 9 9/11/2009) 104 AFTR 2d ¶ 2009-5345, cert denied 2/22/2010:** Taxpayer cannot avoid related party rules by using a QI to acquire replacement property from a related party

2. **Goolsby v. Commissioner (April 1, 2010); T.C. Memo. 2010-64:** Property acquired by taxpayer in an exchange did not qualify as replacement property when taxpayer moved into property two months after acquiring it.

3. **Oregon Department of Revenue v. Marks, TC 4797 (Nov 2, 2009); Order Denying Defendant's Motion for Partial Summary Judgment:**

Oregon Tax Court upheld a “swap and drop” exchange involving a partnership interest.

4. **Rev. Proc 2010-14:** Safe harbor for reporting gain when a QI defaults

5. **Private Letter Ruling 201024036 (6/18/2010):** Exchange of emission credits

6. **ILM 201013038 (April 2, 2010):** Acquisition of Replacement Property Equipment from Related Party Dealer Violates Section 1031 (f)

7. **PMTA 2010-005:** Variance from Rev. Proc. 2002-22 (guidance on TIC interests) allowed when master tenant is bankrupt

D. 2009 Update

1. **Ocmulgee Fields, Inc. v. C.I.R. 132 TC 6 (March 31, 2009):** Related Parties

2. **Private Letter Ruling 200842019:** Exchange of leaseholds and personal property.

3. **Private Letter Ruling 200901004:** IRS implicitly approves non-safe-harbor construction exchange on taxpayer property.

4. **Private Letter Ruling 200901020:** Exchange of residential density development rights.

5. **Private Letter Ruling 200912004:** Cars like-kind to light duty trucks.

6. **ILM 200911006:** IRS reconsiders position on intangibles

7. **Private Letter Ruling 200919027:** Trust for deceased sister’s family is not a related party.

8. **Private Letter Ruling 200921009:** Partnership division during Section 1033 replacement period.

9. **IRS Form 1065:** Amendments to from regarding exchanges of partnerships for 2008 returns.

10. **Section 121:** Amendment concerning gain exclusion on a personal residence for non-qualified use.

E. 2008 Update

1. **Farm Bill Amendment to Section 1031:** Mutual ditch, reservoir, or irrigation company stock qualifies for exchange treatment.

2. **Housing Assistance Act of 2008:** Amendment to Section 121 placing limits on gain exclusions for exchangers who convert investment property to a personal residence.

3. **Revenue Procedure 2008-16:** Safe harbor for exchanges of vacation homes and conversions to or from personal residences.

4. **Private Letter Rulings 200820017 and 200820025** Related parties both exchanging.

5. **Private Letter Rulings 200803003 and 200803014:** IRS issues pair of rulings on bank-owned qualified intermediaries.

6. **Private Letter Ruling 200807005:** Acquisition of 100% of partnership interests is same as acquiring replacement property.

7. **Private Letter Ruling 200812012:** Tax termination of LLC holding replacement property does not disqualify prior exchange.

8. **Private Letter Rulings 200829012 and 200829103:** Two Party TIC Arrangements Approved.

9. **FAA 20074401F:** Newspaper mastheads, advertiser accounts and subscriber accounts.

10. **Private Letter Ruling 200805012:** Development rights are like-kind property.

11. **Private Letter Ruling 200824018:** Holding period of replacement property includes that of relinquished property for purposes of prohibited transactions rule for REIT.

12. **Fact Sheet 2008-18:** Information for taxpayers regarding exchanges under IRC Section 1031.

13. **Proposed Form 1065:** IRS looking for information on partnership exchanges.

F. 2007 Update

1. **Barry E. Moore et Ux. v. Commissioner; T.C. Memo. 2007-134 (May 30, 2007):** Vacation home is not held for investment under §1031.

2. **Prop. Reg. 1.263(a)-2(d)(3):** Confirms that QI fees are capitalized into basis of replacement property and not deductible as business expense.

3. **T.D. 9314, 02/26/2007:** Final regulations issued for depreciation of MACRS property acquired in a §1031 exchange.

4. **Private Letter Ruling 200649028:** Grant of stewardship easement for land use credits qualified as relinquished property in an exchange transaction.

5. **Private Letter Ruling 200651030:** Trust termination after relinquished property agreement is executed does not disallow exchange by distribute LLC.

6. **Private Letter Ruling 200701008; 200728037:** An exchange by an operating partnership of a REIT is not a sale of property under §857(b)(6).

7. **Private Letter Ruling 200706001:** Related party exchange does not involve basis shifting when tax bases are equal.

8. **Private Letter Ruling 200709036:** Related party rules do not apply where related party acquires relinquished property and transfers it within two years.

9. **Private Letter Ruling 200712013:** Related party rules do not apply where a related party acquires relinquished property in a reverse exchange and transfers in two years.

10. **Private Letter Ruling 200730002:** Family partition qualifies for exception to related party rules.

11. **Treasury Inspector General for Tax Administration Report:** Final Audit Report: Like-kind exchange require oversight to ensure taxpayer compliance (September 17, 2007).

G. 2006 Update

1. **Private Letter Ruling 200527011:** Trust distribution of replacement property is permissible.

2. **Private Letter Ruling 200541037:** It is permissible to cut timber on replacement property in a related party exchange.

3. **Temp Reg. Sec. 1.932-1T(g)(1)(ii)(E):** Guam and Northern Mariana Islands, U.S. Virgin Islands can be like-kind to US property.

4. **TAM 200602034:** Intangible property ruling expands scope of like class safe harbor.

5. **Private Letter Ruling 2005320008:** FCC Spectrum rights.

6. **Private Letter Ruling 200616005:** Certain related party exchanges are permissible.

7. **Stewart v. Commissioner; T.C. Summ. Op. 2006-37; No 13167-04S:** Danger of early release of exchange funds from qualified intermediary.

8. **Roy L. Hall v. Glenn's Ferry Grazing Association; No. CV-030386-S, (3/906):** Reverse exchange safe harbor – equitable interest of taxpayer.

9. **Revenue Procedure 2005-27:** Disaster relief.

10. **Private Letter Rulings 200625009 & 200625010:** "Private" TIC Interest OK under Rev. Proc. 2002-22.

11. **Private Letter Ruling 200630005:** Non-disqualification of a party related to a qualified intermediary that provides routine financial services.

12. **Private Letter Ruling 200631012:** Cooperative apartment is OK as replacement property.

13. **Peabody Natural Resources Company v. Commissioner, 126 TC No. 14 (06/08/06):** Supply contracts included in purchase of replacement property are not boot.

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ACKNOWLEDGEMENTS

Case citations and headings were prepared by Mary B. Foster, Esq., for inclusion in Federation of Exchange Accommodators ("FEA") tax update materials.

Examples/problems contained herein are reproduced from 2007 University of Illinois Federal Tax Workbook (Chapter 4 – Like-Kind Exchanges) – copyright Board of Trustees of the University of Illinois (Oct., 2007). They were updated for 2012 usage.

TAX NAVIGATION IN A NEW ERA

1031 Techniques and Strategies

David A. Brown, JD, CES
President, IPE 1031

QUALIFIED INTERMEDIARY SERVICES

www.IPE1031.com

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Sale of $1,000,000 Asset in 2012

TAX CALCULATION:

Federal Capital Gains Tax:	$150,000	($1,000,000 x 15%)
State Capital Gains Tax:	$ 90,000	($1,000,000 x 9%)
Total Tax Paid:	$240,000	
Funds After Tax:	**$760,000**	

(Assumes $0 Basis)

2013 and Beyond: Goodbye 15% Capital Gains Tax Rate Hello 25% for High Earners

Gain due to appreciation

- 15% up to $200,000 (single) $250,000 (married)
- 3.8% Medicare Surtax for earners over $200,000 (single) $250,000 (married)
- 20% for earners over $400,000 (single) $450,000 (married) plus 1.2% phase-out of itemized deductions

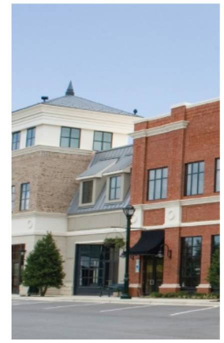
Gain due to depreciation (25%)

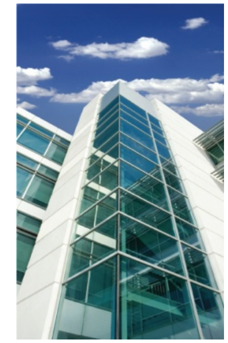
Iowa capital gains (Ordinary Income – up to 8.98%)

Gain on properties held less than one year (Ordinary Income)

34% (IA) potential tax for income over $450,000

QUALIFIED INTERMEDIARY SERVICES





Sale of $1,000,000 Asset in 2013

TAX CALCULATION:

Federal Capital Gains Tax:	$200,000	($1,000,000 x 20%)
Federal Medicare Surcharge:	$ 50,000	($1,000,000 x 5%)
State Capital Gains Tax:	$ 90,000	($1,000,000 x 9%)
Total Tax Paid:	**$340,000**	
Funds After Tax:	$660,000	v. $1,000,000

(Assumes $0 Basis)

QUALIFIED INTERMEDIARY SERVICES

Four Options with a Property

1. Hold
2. Cash Out
3. Installment Sale
4. 1031 Exchange

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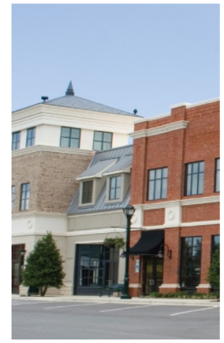
INTERMEDIARY
SERVICES

Reasons to Hold

- Strong asset (cash flow, future appreciation)
- Simply don’t want to pay tax
- Estate planning - stepped up basis for heirs

QUALIFIED INTERMEDIARY SERVICES



Reasons to Cash Out

- Reduce debt
- Low capital gains tax rates for 2012
- Diversify into different asset classes
- Start a 1031 exchange but can’t find suitably priced replacement property



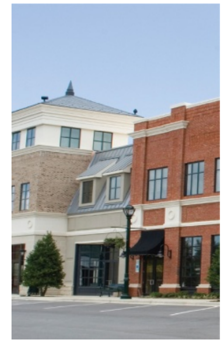
QUALIFIED INTERMEDIARY SERVICES

Installment Sale – Receive Payments Over Time

GAIN CALCULATION:

$	1,000,000	Sale Price of Property (2013)
-	200,000	Basis of Property (1988 Purchase)
	800,000	Gain

Year Taxed	Funds Received	Basis	Amount Taxed	Tax
2013 (15% Fed / 7% State)	$200,000	$40,000	$160,000	$35,200
2014 (22%)	$200,000	$40,000	$160,000	$35,200
2015 (22%)	$200,000	$40,000	$160,000	$35,200
2016 (22%)	$200,000	$40,000	$160,000	$35,200
2017 (22%)	$200,000	$40,000	$160,000	$35,200
Total	**$1,000,000**	**$200,000**	**$800,000**	**$176,000**



Benefit of Section 1031?

- Held for investment or used in trade or business
- Use <u>all</u> proceeds from the sale of old property to buy new property
- Interest-free loan from Uncle Sam

QUALIFIED INTERMEDIARY SERVICES

Red Flag No. 1: Not Asking the Right Questions

- Type of Property Being Relinquished
- Length of Ownership
- FMV / Basis / Gain of Relinquished
- Debt on the Property
- How Title is Held / Nature of Entity Business
- Replacement Property Type
- Value of Replacement Property
- Improvements
- Related Party Replacement Property Seller
- How Title to be Held for Replacement

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Qualifying Like-Kind Properties Include:

- Rental properties (houses, duplexes, apartment complexes, etc.)
- Farms and farm land (except homestead)
- Office buildings
- Retail spaces (strip malls, stand alone stores, gas stations, etc.)
- Industrial and warehouse facilities
- Mini-storage units
- Raw land (land held for speculation)
- Golf courses and sporting complexes
- Vacation homes – <u>under very limited circumstances</u>
- Partial Interests – TIC %, permanent conservation easements, leases (30 Years or More)

Retirement Planning

Farmer and spouse own 1000 acres:

2012: Sell 100 acres for $500,000 (In two years, taxpayer plans to retire to Boise, ID, to be near grandkids, Arizona, Guam or Northern Mariana Islands).

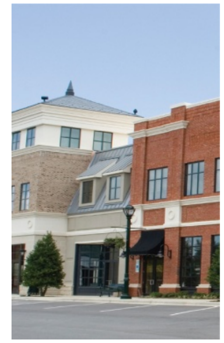
2012: Exchange farmland into Boise loft – rent it for two years (couple has an <u>indeterminate</u> intent to eventually use it for personal residence).

2014: Sell farmhouse (personal residence – § 121 gain exclusion).

2014: Move into Boise loft (now converted to a personal residence).

2017: Want to move south to Hot Springs, Arkansas – (§ 121 gain exclusion).

QUALIFIED
INTERMEDIARY
SERVICES



Red Flag No. 2: Fear and Lack of Use of Reverse and Improvement Exchanges

Exchangers may be confronted with situations where they cannot sell relinquished property(ies) before they buy replacement property(ies):

- Exceptional purchasing opportunities
- Relinquished property cannot be sold before replacement property closing
- Improvements are to be built on replacement property
- Planned events: Increased time flexibility

Red Flag No. 3: Purchase Agreement Defects

- Assignable
  - Foreclosures specifically
- Cooperation Language Options
- All Exchangers Parties to the Contract
- Closing Dates in Sequence (Reverse Exchange)
- 1031 Disclosure in Replacement Property Agreement

Red Flag No. 4: The Disqualified Qualified Intermediary

- Must designate QI prior to close of relinquished property
  - Cannot simply hold funds in escrow
- Cannot be agent of taxpayer
- Attribution Rules: Who is the owner of the QI?
- Exchange Funds Practices

Red Flag No. 5: Trading Down in Value

To defer <u>all</u> capital gain:

1. The replacement property must have a value that is equal to or greater than the sale price of the relinquished property.

2. The exchanger must place all of the equity from the sale of their relinquished property into the replacement property.

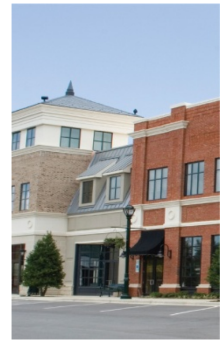
3. The replacement property must have debt that is equal to or greater than that of the relinquished property.

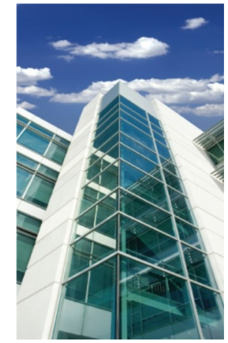
IPE 1031 QUALIFIED INTERMEDIARY SERVICES

Red Flag No. 5: Trading Down in Value

	Relinquished Property	Replacement Property	
Sale Price:	$1,000,000	$ 800,000	↓
Debt:	$ 500,000	$ 300,000	↓
Equity:	$ 500,000	$ 500,000	=

If the taxpayer “trades down” in sale price, debt, or equity, he/she will be taxed on the amount of the “trade down” up to their realized gain.





Receipt of Cash Always Taxable

	Relinquished Property	Replacement Property	
Sale Price:	$1,000,000	$1,200,000	↑
Debt:	$ 500,000	$ 800,000	↑
Equity:	$ 500,000	$ 400,000	↓

The exchanger acquired replacement property worth $200,000 more than the value of relinquished property and received $100,000 cash from the exchange. Cash is not like-kind to real estate. Mortgage debt incurred does not offset cash boot received. The exchanger will pay tax on $100,000.

Pre and Post Exchange Financing

- Case law supports proposition that a taxpayer can take equity out of property before or after the exchange.
  - Should not be done in anticipation of an exchange
  - Best to have an independent economic significance from the exchange
  - Dangers: The I.R.S. does not condone

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Red Flag No. 6: Properties Held for Resale, Dealers, Flippers and Non-qualifying Uses

- Avoiding Dealer Status
- Properties Held for Resale Do Not Qualify
  - Contract Rights
  - Flippers
  - Apartment to Condo Conversions

Red Flag No. 7: Improper Documentation of the Exchange

- Notice of Assignment
  - All Parties
  - Signed by all non-exchanging parties

- Partial Assignments
  - Boot excepted
  - Personal residence (relinquished and replacement)
  - Replacement: Intent to exchange into specific parcel

- Real Estate Installment Sale
  - Relinquished
  - Replacement



Red Flag No. 7: Improper Documentation of the Exchange

- Closing Documents
  - Deed Review
  - Transfer of 100% of LLC Units
  - Title Opinion / Commitment Review
  - Signed Closing Instructions
  - Settlement Statement Review

- Identification Letter
  - Signed By All Parties to the Exchange
  - Must be Specific
  - Improvements listed

- Time Periods
  - 45 Day ID Period: No room for being the accommodating accommodator
  - 180 Day Exchange Period: Request extension of tax return

Red Flag No. 7: Improper Documentation of the Exchange

- Early Release of Funds
- Copy of File for Exchanger and Advisor

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Red Flag No. 8: Settlement Statement Problems

- Permitted Exchange Expenses
- Debt Payoffs Related to Relinquished Property
- Rents and Deposits
- All Exchange Equity Applied to Replacement Purchase
- Over Financing on Replacement

Red Flag No. 9: Prohibited Related Party Transactions

- Basic Rule: Related parties can exchange property if both parties hold replacement properties for two years.

- **MISTAKE:** Common Misconception - An exchanger can acquire replacement property from a related party in a deferred exchange if they sold relinquished property to an unrelated party as long as held for two years.

- I.R.S. prohibits basis shifting.

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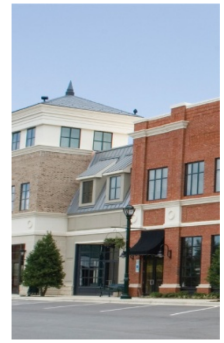

Red Flag No. 10: Partnership Exchanges

- Multi-member LLCs are Typically Partnerships for Tax Purposes
- Drop and Swap
- Swap and Drop
- Special Allocations to Retiring Partners

Use Us As Your Resource

Please do not hesitate to call us if you have questions about a client's transaction or Section 1031 generally.

QUALIFIED INTERMEDIARY SERVICES

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