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1031 tax-deferred Exchanges

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Capital Gain Taxation

Includes 4 components:

1) Taxation on depreciation recapture (25%), plus
2) Federal capital gain taxes at 20% (or 15%), plus
3) 3.8% tax on net investment income, plus
4) Applicable state tax rate (0%-13.3%)

What is a 1031 exchange?

It is a method of deferring the capital gains tax on the sale of qualifying property by exchanging property for other qualifying property.

Allows taxpayers holding property for investment/business purposes to potentially defer all taxes that would otherwise be incurred upon the sale of such property.

Corporate Exchange Services ("CES") is a Qualified Intermediary which drafts the documents necessary and is the vehicle to accomplish this.

TAXES Upon Sale

Upon Sale: Taxed on the Gain

Exceptions:

1) Principal Residence
2) 1031 Exchange

1031 Activity is up!

- Higher capital gains taxes (20% for high earners—i.e. $400k for single/$450k married)
- 3.8% net investment tax (medicare surtax—net investment income who exceed $200k for single; $250k married)
- Increased valuation and appreciation; rising rents
- Rebounding markets
- Depreciation recapture (25%)
- Average tax increase to taxpayers of 58%

Operative Language

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

Capital Gain on Sale of Duplex

Current Fair Market Value	=	$300,000.00
Adjusted Basis	=	$100,000.00
Gain	=	$200,000.00
Capital Gains Tax (15%)	=	$ 30,000.00
Capital Gains Tax (20%)	=	$ 40,000.00
plus depreciation recapture (25%)	=	$ 80,000/90,000

Bottom line: An IRC Section 1031 exchange can provide real estate investors with a huge tax advantage.

General Requirements of the IRS

1.) Exchange

- **Must be a true exchange of Property, not a sale and reinvestment.**
- **Receipt of Funds:** Neither the Taxpayer, nor an agent of the Taxpayer, may receive **or have actual or constructive receipt of or control over** the proceeds of the sale of the Relinquished Property. These funds must be paid directly to the Qualified Intermediary **at closing.**

Terminology

Taxpayer = Party attempting to defer capital gains. Sometimes referred to the Exchangor. Keep Taxpayer consistent throughout exchange.

Relinquished Property = Property the Taxpayer seeks to dispose of in the exchange.

Replacement Property = Property the Taxpayer seeks to acquire in the exchange.

Buyer = Purchaser of the Relinquished Property.

Seller = Seller of the Replacement Property.

General Requirements- Continued

2. Time Constraints

A) Identification Period: The Taxpayer must identify the Replacement Properties by **written notification** to the Qualified Intermediary, **signed by the Taxpayer,** no later than 45 days after the closing of the Relinquished Property.

- Three Property Rule: The Taxpayer may identify up to 3 Replacement Properties without regard to the fair market value ("FMV") of the properties.
- 200% Rule: If the Taxpayer identifies more than 3 Replacement Properties, the total FMV of the properties combined may not exceed 200% of the FMV of the Relinquished Property.
- 95% rule. If the Taxpayer exceeds the two tests set forth above, the Taxpayer must acquire 95% of all Replacement Properties identified.

Terminology - continued

Qualified Intermediary = Party who enters into the Exchange Agreement with the Taxpayer, acquires the Relinquished Property from the Taxpayer, transfers the Relinquished Property to the Buyer, escrows and the invests the proceeds from the transfer of the Relinquished Property, acquires the Replacement Property from the Seller, and transfers the Replacement Property to the Taxpayer.

Accommodation Titleholder = Entity that acquires the Replacement Property in a reverse exchange on behalf of the Taxpayer.

Qualified Exchange Accommodation Agreement = Agreement between the Taxpayer and Accommodation Titleholder addressing the parties responsibilities in a reverse exchange.

Proper Identification

- Any Replacement Property that is not identified within the Identification Period will not be considered "like-kind" to the Relinquished Property.
- Identification must be made prior to midnight on the 45th day after the Relinquished Property closing.
- The identification must unambiguously identify the Replacement property.
- Technically, must be delivered to at least one party to the exchange who is not a Disqualified Person.
- Deadline cannot be extended for any reason (well...almost any reason):
  - Federal Disaster Area
  - Service in Combat Zone (Rev. Proc. 2007-56)

- Multiple Relinquished Properties: Transfer of 1st Relinquished Property starts the Identification Period. If more than 1 Relinquished Property is to be exchanged into one Replacement Property-% or value of interest.
- Replacement Property to be produced.
- Presumed Identification: Any property received during the 45 day Identification period is deemed to have been timely and properly identified.
- May identify or revoke as many times and as many properties as taxpayer desires during 45 days.

Substantially the same: Replacement Property must be substantially the same as the property that was identified.

Regulations use 75% as an example of "substantially the same".

Same in nature or character as identified.

Disqualified Persons

Taxpayer's:

-Employee
-Attorney
-Accountant
-Realtor
-Banker
-Broker
-Relatives (direct line)

Can be delivered to a party obligated to transfer the Replacement Property to the Taxpayer

General Rule of Tax Deferral

To completely defer taxable gain in an exchange, the Taxpayer must trade up or equal in both value and equity from the Relinquished Property to the Replacement Property.

A Taxpayer may trade down and partially defer the gain. Any money a taxpayer pulls out of an exchange or receives back at the termination of the exchange is taxable. (Mortgage boot possible).

General Requirements-Continued

2. Time Constraints

B) Acquisition Period

- The Taxpayer must close on the acquisition of the Replacement Property no later than **180 days** after the closing of the Relinquished Property, **or the due date of the Taxpayer's tax return, including extensions, whichever is earlier.**

What type of property qualifies for an Exchange?

Both real and personal property may be exchanged.

Must be property that is either:
- Held for productive use in a trade or business
- Held for investment

- Liberal definition of "Like-Kind" for real property
- US and Virgin Islands
- Fee; 30 year leasehold; partial interest; oil and gas royalty interest; perpetual water rights; easement; vacant; improved; multiple properties

Exceptions:

- Stock in Trade or other property held primarily for sale
- Stocks, bonds or notes
- Interests in a partnership
- Other securities or evidences of debt
- Certificates of trust or beneficial interest
- Choses in action

Rev Proc. 2008-16

On February 15, 2008, the IRS issued Revenue Procedure ("Rev. Proc.") **2008-16**, effective for exchanges occurring on or after March 10, 2008, which provides a safe harbor for exchanges of vacation homes ("dwelling unit"). Taxpayers must satisfy qualifying use standards during the **24-month period** prior to the exchange.

Vacation Homes (prior to 2/08)

-May qualify if personal use is minimal (<14 days/10% of time rented)

-Loss from the sale or exchange of the home is deductible

- Personal use includes use by: taxpayer, anyone who has in interest in the dwelling (tenant in common), anyone who uses the dwelling under an arrangement which enables the taxpayer to use some other dwelling; or by anyone if rented for less than fair market value.

-A 2 week timeshare used for vacation purposes will not qualify even though it meets the 14 day period.

Relinquished Property

For a dwelling unit to qualify as relinquished property, it must meet the following criteria:

1) The dwelling unit is owned by the taxpayer for at least 24 months immediately before the exchange (the "qualifying use period"); **and**
2) Within the qualifying use period, in each of the two 12-month periods immediately preceding the exchange:

Qualifying a 2nd home for a 1031

What may help qualify a 2nd home?

-During the year of the exchange, taxpayer should not exceed the personal use limits of Section 280A of the IRC (greater of 14 days/10% of days rented at FMV) and/or should rent the property at fair market value at least during that year, or longer.

-Declare it as an investment on tax returns for at least 1 tax year or longer.

-Deduct the interest as investment interest rather than deducting mortgage interest as a second home.

-Intent.

(a) the taxpayer rents the dwelling unit at fair rental to another person/ persons/ people for 14 days or more **and**

(b) the taxpayer's personal use of the dwelling unit does not exceed the greater of 14 days or 10 percent of the number of days during the 12-month period that the dwelling unit is rented at fair rental value.

Replacement Property

For a dwelling unit to qualify as replacement property, it must meet the following criteria:

1) It is owned by the taxpayer for at least 24 months immediately following the exchange ("qualifying use period"); **and**

2) Within the qualifying use period, in each of the two 12 month periods immediately after the exchange:

Fair rental. Fair rental is determined based upon all of the facts and circumstances that exist when the rental agreement is entered into. All rights and obligations of the rental agreement are taken into account.

a) the taxpayer rents the dwelling unit to another person/persons/people at fair rental for 14 days or more **and**

b) the taxpayer's personal use of the dwelling unit does not exceed the greater of 14 days or 10 percent of the number of days during the 12-month period that the dwelling unit was rented at fair rental value.

Exchanges of 2nd/vacation homes outside the Rev. Proc. 2008-16 safe harbor. An exchange of a vacation home may still qualify under §1031 even though it falls outside the parameters of Rev. Proc. 2008-16. Any such circumstance will be subject to greater scrutiny and therefore should be carefully planned and reviewed by the taxpayer's tax advisor.

Reminder: Personal Use

Personal Use.

- Use by the taxpayer or other person having an interest in the dwelling unit and any family member (includes siblings, spouse, ancestors and lineal descendants) will be considered "personal use" by the taxpayer.
- Any arrangement whereby fair market rent is not paid will be considered "personal use" by the taxpayer.
- Caveat: Use by family members will not be considered "personal use" by the taxpayer if the dwelling unit is rented at fair market rent and the family member uses it as his principal residence.

Factors

- Intent
- Objective factors to support or negate intent to hold for investment-rental or attempt to rent
- All facts & circumstances
- Holding period—just one of the factors

Reverse Exchange

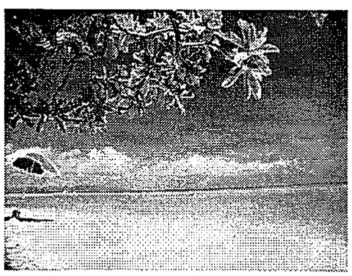
Used when the Taxpayer must complete the purchase of the Replacement Property prior to the sale of the Relinquished Property.

This was sanctioned in 2000 under Rev Proc. 2000-37

Reverse Exchange

<u>Key Points continued:</u>

- The sale/transfer of the Relinquished Property occurs similar to a forward exchange. The QI receives the sale proceeds and pays them to the AT in exchange for the AT transferring the Replacement Property to the Taxpayer.
- A reverse exchange is more complicated, requires more documentation and is more expensive than a forward exchange. So, it is good advice to your client to structure a forward exchange if at all possible.



Elimination of Tax

*Death

*Conversion-closed the loophole

THEN: Buy replacement property in a 1031 exchange

Rent it out for two years

Convert the use to principal residence for an additional two years, and take the gain exclusion under I.R.C. section 121.

NOW: LIMITATION: For any 1031 exchange that takes place after January 1, 2009 gain will be apportioned between the time when the replacement property is held as rental and the time it is held for principle residence.

Example: Property is bought in June 2009 and is used as a rental for 2 years. Then it is converted to principal residence and used as principal residence for three years until June 2014 at which time it is sold. In this example 60% of the gain (3 years) is excluded under section 121 and 40% of the gain (2 years) is taxed. (CAUTION: Recaptured depreciation must also be taken upon sale of any property in which the gain is otherwise excluded under section 121. Most of the rules set forth in the article are contained in I.R.C. section 121).

Reverse Exchange

<u>Key Points:</u>

- Taxpayer may **not take title to the Replacement Property** until the Relinquished Property has been sold.
- Typically, **a single member** sole purpose Limited Liability Company is created to purchase the Replacement Property on behalf of the Taxpayer. This entity is referred to as the **Accommodation Titleholder ("AT")**.
- The AT holds or "parks" the Replacement Property until the Relinquished Property is sold.
- The AT either borrows the funds necessary to purchase the Replacement Property from the Taxpayer or a conventional Lender <u>(non-recourse loan).</u> Taxpayer may personally guarantee the loan.
- The same 45 day and 180 day deadlines apply but in reverse.

Advantages of a 1031 Exchange

- Expand portfolio/diversify or consolidate investments
- Obtain rental income
- Exchange into more expensive investment
- Relocation of investment
- Every exchange has at least 2 closings

Purchase Agreement Language

IT IS AGREED BETWEEN PURCHASER AND SELLER AS FOLLOWS: A material part of the consideration to purchaser (seller) for purchasing (selling) is that the Purchaser (seller) has the option to qualify this transaction as part of a tax-deferred exchange under Section 1031 of the Internal Revenue Code of Seller (Purchaser) agrees that Purchaser (Seller) may Assign this Agreement for that purpose.

Proposals calling for repeal/limitation of 1031

- House Bill H.R. 1/the Tax Reform Act of 2014-called for repeal of Sec. 1031. Status: Expired.
- Senate Finance Committee report: Comprehensive Tax Reform for 2015 and Beyond. Lists like-kind exchanges as 3rd largest expenditure.

What now?

- Mention the availability of a 1031 exchange.
- Have them contact me: 231-237-1100 or msnabes@Corp1031.com
- Website: www.corp1031.com
  - capital gains calculator/45 & 180 day calculator/links

- Treasury's FY 2015 Budget: proposed limiting real property exchanges to $1m annual gain deferral, but was silent about personal property exchanges.
- Senate Finance Committee's "Discussion Draft: Cost Recovery and Accounting." Proposed to repeal 1031, but leaves door open for real and intangible property exchange & possible modification of the like-kind standard to narrower Sec. 1033 standard, requiring properties be similar in service or use.

Why Corporate Exchange Services?

The Company was formed in 1995 and has over 20 years and 500 exchanges-forward, reverse and build-to-suit, exchanges under its belt.

CES is a member of the Federation of Exchange Accommodators and in October, 2006, Maura A. Snabes, passed the certification exam for qualified intermediaries and is a Certified Exchange Specialist. She is one of only 7 in Michigan.

Our competitors can't and don't provide the personal service your clients want or deserve.

By using Corporate Exchange Services, a taxpayer substantially reduces the risk of the 1031 being set aside by the IRS.

When necessary, we always seek the support of a qualified, knowledgeable tax professional.

FEA's response

Numerous fly-ins to Washington DC for meetings on the Hill.

Economic Studies: Ernst & Young, LLP Macroeconomic Study-"Economic Impact of Repealing IRS Section 1031"

Microeconomic Study by Ling & Petrova: "The Economic Impact of Repealing or Limiting Section 1031 Like-Kind Exchanges in Real Estate"

Response

- Will cause a decline in real estate values as investors hold properties longer.
- Decrease in investment; increase in holding periods; increase in amount of leverage used to acquire property.
- 1031 in tax code since 1921, based on sound tax policy based upon continuity of investment.
- 1031 stimulates real estate transactions, encourages taxpayers to upgrade equipment, machinery and other assets.

- www.1031taxreform.com

-Increase in rental rates in the long run and decrease in prices in the short run.

-88% of the time investors dispose of properties acquired in an exchange through a taxable sale.

-Fewer transactions ultimately result in fewer jobs in real estate, construction, financial service, vehicle & equipment leasing, manufacturing and other industries.

Questions?

Email: msnabes@corp1031.com

Phone: 231-237-1100

- Like-kind exchanges encourage investment.
- Like-kind exchanges contribute significant federal tax revenue.
- Like-kind exchanges lead to job creation.
- Like-kind exchanges result in less debt.