



ASSET PRESERVATION
INCORPORATED

TEN SECTION 1031 EXCHANGE PITFALLS TO AVOID

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DISCLAIMER

This presentation is only intended to provide a broad overview of IRC Section 1031 tax deferred exchanges and does not address every potential 1031 exchange situation or all applicable 1031 exchange rules.

This tax-related information should not be construed as tax or legal advice specific to your situation and should not be relied upon in making any business, legal or tax related decision. A proper evaluation of the benefits and risks associated with a particular transaction or tax return position often requires advice from a competent tax and/or legal advisor familiar with your specific transaction, objectives and the relevant facts. You are urged to involve your tax and/or legal advisor (or to seek such advice) in any significant real estate or business related transaction.

#1 EXCHANGE PITFALL: TIMING RE: SALE

- Timing: Attempting to initiate a 1031 exchange at the last minute.
- Timing: Opting not to set up a 1031 exchange prior to closing on the sale of the relinquished property.
- Every month there are hundreds (if not thousands) of investors who really wanted an option to defer capital gain taxes with a 1031 exchange....but they failed to set up an exchange before closing on the sale transaction.
- There is no opportunity to set up a 1031 exchange after closing.
- Understanding “constructive receipt” and “actual receipt”

#2 EXCHANGE PITFALL: TIMING RE: PURCHASE

- Timing: Not looking for replacement property early enough in the transaction.
- In today's seller's market, with many well-priced properties selling quickly, an investor should begin looking for suitable replacement property at the time the relinquished property is listed for sale.
- In today's seller's market, the listing price (which traditionally has been the ceiling for purchase price) is now often the floor price for buyers. Many sellers are receiving multiple offers with escalation clauses and potential buyers are bidding up the final purchase price.
- 1031 exchange investors need to adapt to the challenges of current market conditions when inventory is low and properties get under contract very quickly (often within days if priced properly.)

TIME REQUIREMENTS



▶ 45 Day Identification Period:

The taxpayer must identify potential replacement property(s) by midnight of the 45th day from the date of sale.



▶ 180 Day Exchange Period:

The taxpayer must acquire the replacement property by midnight of the 180th day, or the date the taxpayer must file its tax return (including extensions) for the year of the transfer of the relinquished property, whichever is earlier.

#3 EXCHANGE PITFALL: NO BACKUP PROPERTIES

- Not identifying back-up replacement properties within the 45-day Identification Period.

IDENTIFICATION RULES

3 Property Rule

The taxpayer may identify up to three properties of any fair market value.

200% Rule

The taxpayer may identify an unlimited number of properties provided the total fair market value of all properties identified does not exceed 200% of the fair market value of the relinquished property.

95% Rule

If the taxpayer identifies properties in excess of both of the other rules, then the investor must acquire 95% of the value of all properties identified.



IDENTIFICATION RULES

Identification must be:

- Made in writing
- Unambiguously describe the property
- Hand delivered, mailed, telecopied or otherwise sent
- Sent by midnight of the 45th day
- Delivered to the qualified intermediary or a party related to the exchange who is not a disqualified person

#4 EXCHANGE PITFALL: LLC/PARTNERSHIP ISSUES

- LLC / Partnership Issues: Situations where some LLC members or partners want to receive proceeds which are taxable and other LLC members or partners want to structure a 1031 exchange for tax deferral.
- To achieve tax deferral, investors who want to exchange must convert a former LLC/Partnership interest in a LLC or partnership into tenant-in-common ownership (where the investor directly owns real estate) in real property prior to closing on the sale of the relinquished property.

§1031 - PARTNERSHIP ISSUES

- **A Partnership/LLC 1031 Exchange Scenario:** A property is owned by a partnership/LLC. Some partners may want the partnership to stay together and do a 1031 exchange; others may want to do their own separate exchange with their portion of the property; others may want to receive cash and pay the taxes owed.
- The fact the partnership owns a capital asset does not mean the partners have an ownership interest in that asset.
- The partners merely own partnership interests.
- Partnership interests are specifically excluded from Section 1031 under section 1031(a)(2)(D).
- Therefore, if a partner wants to exchange, they must convert the partnership interest into an interest in the capital asset owned by the partnership.

§1031 - PARTNERSHIP ISSUES

- **“Drop and Swap”** - Involves the liquidation of a partnership interest by distributing an interest in the property owned by the partnership.
- After completing the “drop” the former partner will have converted their partnership interest into an interest in the actual property, as a tenant-in-common with the partnership.
- The property can then be sold with the former partner and the partnership entitled to do what they wish (sale or exchange) with their respective interests.
- **“Swap and Drop”** - This alternative involves the same two steps, but in the reverse order. The partnership completes the exchange (the “swap”) and then distributes an interest in the replacement property to the departing partner.

§1031 - PARTNERSHIP ISSUES

Holding Period Issues:

- If the “drop” occurs close in time to the “swap” (or visa versa) there may be a question as to whether the relinquished property (or replacement property) was “held for investment.”
- If the “drop” occurs too close to the “swap”, the partner’s exchange may be deemed an exchange by the partnership under the *Court Holdings* case.
- The more time that passes between the “drop” and “swap” the better.

§1031 - PARTNERSHIP ISSUES

Holding Period Issues:

- Numerous federal cases (*Bolker, Mason, Maloney*) provide taxpayer-friendly authority against challenges by the IRS.
- Some state tax authorities, such as the Franchise Tax Board (FTB) in California, challenge the federal cases and argue they are not bound by the federal cases.
- Changes made in 2008 to the federal partnership tax return (IRS Form 1065) make it easier to detect when a drop and swap transaction has occurred, thus making such transactions more vulnerable to challenge by taxing authorities.

#5 EXCHANGE PITFALL: FULL TAX DEFERRAL

- Not understanding the requirements for full tax deferral. In particular, the need to have the same or greater amount of debt as well as reinvesting net proceeds.
- To achieve full tax deferral in a 1031 exchange, a taxpayer must purchase like-kind replacement property for at least the amount of the net sales price of the relinquished property and take on the same or greater amount of debt on the replacement property as was on the relinquished property (or add cash to the transaction to make up the debt amount). If the taxpayer fails to take on equal or greater debt on the replacement property being purchased, it may result in taxable boot in the form of debt relief (also called mortgage boot).
- Cash can be added to offset potential mortgage boot.
- Review: For full tax deferral, an investor should: 1) reinvest all net proceeds and 2) have the same or a greater amount of debt on replacement property.

#6 EXCHANGE PITFALL: HELD FOR INVESTMENT

- Exchanging into property not held for investment or a business purpose.
- The relinquished property sold in a 1031 exchange must be held for investment or for use in a trade or business. Taxpayers that hold property for sale, such as taxpayers who do “fix and flip” transactions or holding for development/sale, do not qualify for a 1031 exchange.
- Likewise, the taxpayer’s intention must be to hold the replacement property for investment or for business purposes. Moving into a replacement property shortly after purchasing in a 1031 exchange does not indicate an intent to hold for investment and would generally result in the exchange being disallowed since the property is not being held for a qualifying investment or business purposes.

#7 EXCHANGE PITFALL: DISQUALIFIED PERSON

- Using a person who is considered “disqualified” as the qualified intermediary.
- A taxpayer cannot have a family member, employee, real estate professional or a tax/legal advisor who gave tax/legal advice within the past two (2) years function as a qualified intermediary in a 1031 exchange. A Qualified Intermediary (“QI”) is a person who:

Is not the taxpayer or a disqualified person;

Enters into a written agreement with the taxpayer (the exchange agreement) under which the qualified intermediary:

Acquires the relinquished property from the taxpayer; Transfers the relinquished property to the buyer; Acquires the replacement property from the seller; Transfers the replacement property to the taxpayer.

The exchange agreement must expressly limit the taxpayer’s rights to receive, pledge, borrow, or otherwise obtain benefits of money or other property held by the qualified intermediary. (See Treasury Regulations §1031.1031(k)-1(g)(4)(i).)

#8 EXCHANGE PITFALL: NOT SEEKING TAX ADVICE

- Not consulting with CPA or tax advisor prior to closing on the sale of the relinquished property.
- Every taxpayer has facts and circumstances that are unique. It is critical to consult with a tax advisor familiar with each taxpayer's specific situation before closing on sale of relinquished property. For example, a taxpayer may have suspended carryforward losses which could potentially be used to offset boot received by the taxpayer. Every taxpayer should review their specific tax situation and evaluate a 1031 exchange transaction with tax/legal advisors familiar with their specific circumstances and the relevant facts.

#9 EXCHANGE PITFALL: EXCHANGE ENTITIES

- Not evaluating both sides of the exchange transaction
- Taxpayers should consider these issues and many more before closing:
 - Who is the “tax owner” of the relinquished property;
 - How title is held on the relinquished property;
 - How title will be held on the replacement property;
 - Financing issues if a husband and wife plan on using both incomes to qualify for a loan and reconciling with how title is held;

EXCHANGE ENTITIES - GENERAL

The same tax owner should take title to the replacement property in the same manner they held title to the relinquished property.

- Wife relinquishes, wife acquires
- Smith LLC relinquishes, Smith LLC acquires
- Gemco Corp. relinquishes, Gemco Corp. acquires
- Durst Partnership relinquishes, Durst Partnership acquires
- However, having the vesting the same is only a guideline.
- The key issue is the 'tax owner' of the relinquished property must acquire tax ownership of the replacement property.

EXCHANGE ENTITIES - EXCEPTIONS

- It is necessary to distinguish between 1) federal tax ownership, 2) state law ownership, and 3) vesting.
- A taxpayer who elects taxation as a sole proprietorship (disregarded entity for Federal tax purposes) can sell relinquished property as an individual but acquire replacement property as a single member LLC.
- An LLC with two members will be considered a single member LLC if the sole role of the other member is to prevent the other member from placing the LLC into bankruptcy and the limited role member LLC has no interest in profits/losses nor any managing rights.

#10 EXCHANGE PITFALL: RELATED PARTY ISSUES

- Purchasing a replacement property from a related party in an exchange.
- A taxpayer should generally not purchase replacement property from a family member or a related entity that is considered a related party. There are very specific guidelines for 1031 exchange transactions involving related parties and different rules apply when swapping real property with a related party, selling to a related party, and purchasing from a related party.

RELATED PARTY

Who is a Related Party?

Four Different Scenarios:

1. Simultaneous Exchange (Swap)
2. Delayed – Selling to a Related Party
3. Delayed – Purchasing from a Related Party
(See Rev. Ruling 2002-83, PLR 9748006)
4. Delayed – Purchasing from a Related Party who is Exchanging (See PLR 2004-40002)

THE API ADVANTAGE



EXPERIENCE • EXPERTISE • SECURITY

THE API ADVANTAGE

- **Experience** - Since 1990, Asset Preservation, Inc. (API) has been a leading national Qualified Intermediary and has successfully completed over 200,000 tax-deferred exchanges.
- **Expertise** – API’s Senior Exchange Counselors provide responsive service and attention to every exchange transaction. API’s Commercial Division handles complex parking arrangement (reverse and improvement) exchanges and multi-site commercial transactions.
- **Security** - API provides unmatched security for the management of exchange funds including the financial strength and backing of Stewart Information Services Corporation (NYSE: STC) under a written “Letter of Assurance” provided on request. API management maintains tight financial controls and multi-layered security systems necessary to provide a level of comfort and the quality of performance relied on by sophisticated investors and Corporate America.

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