



SECTION 1031
LIKE KIND EXCHANGES

SJSU WEBINAR – NOVEMBER 18, 2022

WARREN "SKIP" KESSLER
MICHAEL WIENER
ZACHARY M. NOLAN

1



SECTION 1031 - INTRODUCTION



2

2

WHAT IS A SECTION 1031 TRANSACTION

- Since 1921, Section 1031 of the Internal Revenue Code has allowed investors to postpone paying capital gains taxes on investment property sales if they reinvest the proceeds into a similar investment property within a specified time frame.
 - Section 1031(a): "No gain or loss shall be recognized on the exchange of real property...."
- Generally when you sell business or investment property and you have a gain, you have to pay tax on the gain at the time of the sale. IRC Section 1031 provides an exception and allows you to postpone paying tax on the gain if you reinvest the proceeds in similar property as part of a qualifying like-kind exchange. Gain deferred in a like-kind exchange under IRC
 - NOTE: Section 1031 is tax-deferred, but it is not tax-free.

3

3

BENEFITS OF SECTION 1031

- Tax Deferral
 - Increase purchasing power in the replacement property by freeing up capital as a result of deferral of tax.
- Consolidation of properties
- Diversify properties
- Increase cash flow for operations (swap vacant land for office building with rents)
- Management relief
 - Owning several properties can be an administrative burden and costly. Can swap into something easier to manage.

4

4

MARKET FACTS WITH RESPECT TO SECTION 1031

- According to a 2021 Study performed by EY, the study estimates that 1031 exchanges and their associated activity support approximately 568,000 jobs, generating \$27.5 billion in labor income to the national economy and \$55.3 billion to the U.S. gross domestic product in 2021.
 - <https://thediwire.com/wp-content/uploads/2021/06/EY-FEA-Economic-activity-supported-by-LKE-rules-May-2021-Final-1.pdf>
- A study in 2021 concluded that the share of 1031 exchanges likely range from 10 to 20 percent of all commercial real estate transactions over the sample period.
 - "The Tax and Economic Impacts of Section 1031 Like-Kind Exchanges in Real Estate". David Ling Ph.D., a professor at the University of Florida, and Milena Petrova Ph.D., an associate professor at Syracuse University.
- According to the Ling and Petrova study, 80 percent of properties acquired through an exchange are later sold in a taxable transaction, at which time the tax is paid. The remaining 20 percent includes all non-taxable transfers such eminent domain, partition or other court ordered transfer, divorce, partnership dissolution, gift and death.
 - Shows its not just some "loophole", tax is eventually paid.

5

TYPES OF 1031 TRANSACTIONS

6

SIMULTANEOUS EXCHANGE

- A “simultaneous exchange” is where the Replacement Property and the Relinquished Property are exchanged at the same.
- This exchange only involves two parties, the buyer and the seller.
- Advantage: There is no need for qualified intermediary. The transaction is simple on its face.
- Disadvantage: Hard to find someone who will engage in a property for property exchange.
 - Not very common in the market.

7

7

DEFERRED EXCHANGE

- A “deferred exchange” is where the Relinquished Property is sold first, and the Replacement Property is acquired second.
- This exchange generally involves three parties, the buyer, the seller, and the Intermediary.
- Advantage: Deferred exchanges reduce the time pressure of trying to close the entire transaction simultaneously.
- Disadvantage: Costs of a qualified intermediary, and potential tax counsel.
 - Much more common in the market than simultaneous exchanges.

8

8

REVERSE EXCHANGE

- A “reverse exchange” is where the Replacement Property is acquired first, and the Relinquished Property is sold second.
- This exchange generally involves four parties, the buyer, the seller, the Intermediary, and the Exchange Accommodation Titleholder (the “EAT”).
- Advantage: Allows you to buy a property you like as it becomes available in the market.
- Disadvantage: Need required capital to purchase property without selling other property. Costs of QI and EAT, and potential tax counsel.
 - Much more common in the market than simultaneous exchanges.

9

THE BASICS OF SECTION 1031

10

10

“LIKE KIND PROPERTY” REQUIREMENT

- “Like kind” refers to the nature or character of the property, not to its grade or quality. Reg 1.1031(a)-1(b).
 - There is no distinction between improved and unimproved real estate. These rules are very liberal.

- After the TCJA, the only “property” that qualifies for a 1031 exchange is real property. Section 1031(a).
 - Observation: This means you cannot acquire a partnership interest.
 - Prior to the TCJA, 1031 applied to personal property and intangible property. It was even commonly used by professional sports teams to trade players. (still couldn’t acquire partnership interest prior to 2018).

- 5 real property categories:
 - (1) land;
 - (2) improvements to land;
 - (3) unsevered natural products of land;
 - (4) water and air space superjacent to land; and
 - (5) intangible interests in any of the foregoing.
 - Treasury Regulation 1.1031(a)-3(a)(1).

11

INVESTMENT PROPERTY REQUIREMENT

- Section 1031(a)(1) requires that relinquished property is “held for” and that replacement property “is to be held for” a qualifying purpose, which purpose is either:
 - “productive use in a trade or business” or
 - “investment.”

- As a result, a personal residence, second home, or vacation home would not qualify.

12

12

SAME TAXPAYER/TITLE HOLDER REQUIREMENT

- This comes up most commonly with partnerships.
- Whether the identity of the taxpayer who disposed of the relinquished property and the identity of the taxpayers who acquire the replacement property are the same is a variation of the held for requirement, sometimes referred to as the “same taxpayer” issue.
- Section 1031 is designed to provide nonrecognition when a taxpayer continues his investment in qualifying property.
- As a result, if a partnership sells a property, nonrecognition under Section 1031 is available only if the partnership itself, and not the individual partners, elects to acquire replacement property.

13

1031 BOOT RULES & REQUIREMENTS

- The term “boot” refers to the non-like kind property received in the 1031 exchange.
- The presence of boot does not disqualify a section 1031 exchange, but boot is subject to capital gains tax.
- Generally boot is in the form of cash, installment notes, personal property, or debt relief.
 - “Boot” can be thought of as the amount not “reinvested” into real property
- Section 453 Installment Rules can apply to boot (as used in PINs transactions)

14

NO CONSTRUCTIVE OR ACTUAL RECEIPT OF EXCHANGE FUNDS

- The IRS allows for tax deferral on the money received in the sale of a property because the taxpayer never receives it.
- If the Taxpayer receives proceeds from the sale prior to the lapse of the 180 day exchange period, those proceeds do not qualify for Section 1031 deferral.
- Further, Reg. §1.1031(k)-1(f)(2) provides that actual or constructive receipt of money or property by an agent of the taxpayer (determined without regard to the definition of disqualified person) is actual or constructive receipt by the taxpayer.
- Safe harbor exceptions allowing the proceeds to held by qualified intermediary or an escrow account. Regulation 1.1031(k)-1(g). 15

15

IDENTIFICATION RULES

16

16

45 DAY IDENTIFICATION REQUIREMENT

- Taxpayers have 45 days from the date of the closing in order to identify your potential replacement properties. There are no individual extensions and no exceptions.
- "Identify" does not mean sign the contract. It simply means you have identified it as a potential replacement property.
- 45-day identification rules:
 - Must be made by midnight on the 45th day (generally 45-day period includes weekends and holidays).
 - Failure to make a timely identification will bust the 1031 exchange.
 - Must be unambiguous.
 - must contain enough information to allow the determination that this is the one and only property that fits the description.
 - Must be in writing.
 - oral identifications do not qualify.
 - Must be signed by the Taxpayer.
 - If the Taxpayer is not available, the signer should be appointed as agent pursuant to a written power of attorney.
 - Must be delivered to a party who is not a "disqualified" person.
 - Regulation 1.1031(k)-1(k): Disqualified person is an agent of the taxpayer or a related party.

17

17

GENERAL 3 PROPERTY RULE - IDENTIFICATION

- 3 Property Rule Identify up to three properties of any value with the intent of purchasing at least one.
- This is the most common of the 3 identification methods utilized.

18

18

200% RULE - IDENTIFICATION

- **200% Rule:** Identify more than three properties with an aggregate value that does not exceed 200% of the market value of the relinquished property.
- Under this method, a taxpayer can identify any number of properties and close on any number of them as long as the sum of the market value of all of them does not exceed 200% of the market value of the relinquished property.
 - Note: If this limit is exceeded, the entire exchange is disqualified.
- **Determining FMV:** For purposes of the 200% rule, the fair market value of the designated properties is determined on the 45th day following the sale of your downleg property. If you use the 200% rule, you should err on the high side when it comes to valuations in case an auditor tries to assert that a property's value is greater than you say it is.

19

19

95% RULE - IDENTIFICATION

- Identify more than three properties with an aggregate value exceeding 200% of the relinquished property, knowing that 95% of the market value of all properties identified must be acquired.
- This not very commonly used in the market because of the of the bar of requiring 95% of the value of all properties to be identified.

20

20

180 DAY PURCHASE REQUIREMENT

- Taxpayers must acquire all replacement property within the lessor of 180 days or the date of your next tax filings.
 - Important to be aware it is a “lessor of” rule.
- The 180 day timer starts from the day of the closing (like the 45 day rule)
 - The total number of days is 180 days, NOT 225 days (180 + 45 days).

21

21

REPORTING THE 1031 EXCHANGE

22

22

REPORTING THE I03I EXCHANGE

- Section 1031 exchanges must be reported to the IRS even though no gain or loss is recognized. Taxpayers report such exchanges on Schedule D or Form 4797 (whichever applies) and provide the information required in the instructions.
- In addition, taxpayers must supply detailed information about the exchange on Form 8824 (Like-Kind Exchanges), including descriptions of the property given up and the property received, identification of any related person who is a party to the exchange, and calculations of realized gain, recognized gain, and the basis of like-kind property received.

23

23

STRUCTURING FOR A I03I TRANSACTION

24

24

PARTNERSHIP DIVISION

- It is not uncommon for taxpayers to want to split ways after selling the replacement property. If all taxpayers want to do their own 1031, a partnership division could be the answer. This structure is based on I.R.C. § 708(b)(2)(B) and Treas. Reg. § 1.708-1(d).
- In a partnership division for a 1031:
 - The partnership forms a new LLC (or multiple depending on how many divisions you are doing)
 - The partnership transfers a TIC interest in the property to the new LLC
 - In exchange for the transfer of property to the new LLC, the partnership will receive interest in the new LLC and be the sole member
 - All parties will enter into a division agreement under Section 708(b)(2)(B), pursuant to which the partnership will distribute the majority of the new LLC interest to the partner who will be doing their own 1031 transaction.
 - Important to remember a partnership division requires the members of the resulting partnership had an interest of more than 50% in the capital and profits of the prior partnership.
 - The partnership and the new LLC will each enter their own Section 1031 exchange to exchange their TIC interest in the property with eligible replacement property.
- This allows taxpayers to satisfy the “same taxpayer rule” of 1031, while each doing their own 1031 transaction.

25

25

1031 AND TRAPS FOR THE UNWARY

26

26

SECTION 1031 COMMON MISTAKES

- Not meeting 1031 deadlines
 - Not identifying property within 45 days
 - This is where most 1031 exchanges usually fail, therefore it's important to take it seriously.
 - The 180 day timer starts from the day of the closing (similar to the 45 day rule)
 - The total number is 180 days, NOT 225 days (180 + 45 days).
- Overpaying For A Replacement Property (non tax issue)

27

27

1031 AND TAX INSURANCE

28

28

THOUGHTS FOR THE FUTURE - TAX INSURANCE

- Tax only insurance is a concept that springs from Representation and Warranty Insurance in M&A deals.
- Tax only insurance is a new concept that is typically being used for Section 355 transactions, Section 368 Reorganizations, or whether there is a proper S-election in place.
- Tax only insurance is not really being employed for purposes of section 1031, but it could be potentially beneficial to the market.
- Could provide piece of mind to clients, tax attorneys, and CPAs for an upfront cost.

29