

Section 1031 Exchanges Involving Real Property

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Overview

- Basics of 1031 exchange.
 - Purpose.
 - Definitions.
- Types of exchanges.
- Real estate issues.
- Common pitfalls.
- Attorney's role in 1031 exchange.



1031 Exchange Basics



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IRS Code § 1031(a)(1)

“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.”



Cornbread English



- You can defer capital gains tax when you sell business or investment property if you swap it for the same type of property* ** ***

* Replacement property must be of equal or greater value.

** Exclusions may apply.

*** No representation is made that the quality of the definition above is greater than the quality of the definition provided by the Internal Revenue Service.



Definitions

▪ Property:

- Real property. ✓
- Personal property. ✓
 - Trade or business property.
- Stocks, bonds, or notes. ✗
- Securities or debt. ✗
- Partnership interests. ✗



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▪ **Used in a trade or business.**

- Ownership of the building your business occupies.
 - Real estate office, gas station, restaurant, kissing booth (maybe). ✓

▪ **Held for investment.**

- Holding the property for future appreciation.
 - Raw land, rental houses, commercial property. ✓
 - Personal residence or vacation home. ✗
 - Held for resale (flip house). ✗



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▪ **Like Kind**

- Must receive the same type of property you relinquish.
 - Rental property for cash? ✗
 - Office building for Corvette? ✗
 - Donut shop for personal residence? ✗
 - Gas station for kissing booth? ✗
 - Rental house for cheaper rental house? ✓
 - Amount for NP goes into exchange, and excess cash is taxable
 - Cash in this example is often called “boot”
- Type of real property doesn't matter as long as both old property (OP) and new property (NP) are real property that qualify under § 1031.



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Types of Exchanges



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Main Types of Exchanges

- Simultaneous exchange.
- Forward exchange.
- Reverse exchange.



Simultaneous Exchange



- CBE: deed-swapping
 - Simultaneously exchange ownership of old property for new property
 - Old-fashioned exchange.
 - **MUST** close on **same day** at **same office**.



Forward Exchange

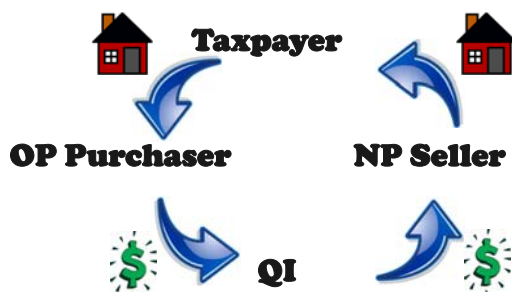


- Most common type of exchange.
- Sell old property first, then buy new property later.
- Must comply with strict rules.



Forward Exchange Rules

- Qualified intermediary (QI)
 - Must select a QI to hold proceeds from old property on your behalf until purchase of new property.
 - If you exercise any control over proceeds, exchange is toast.



Forward Exchange Rules

- **45-Day Rule:**
 - Must provide list **clearly** identifying potential NPs to QI within 45 calendar days of selling OP.
 - “Yellow House on University Dr.” won’t cut it.
 - “456 University Dr., Huntsville, Alabama” is better.
 - NP purchased **MUST** be on the 45-day list.
 - **CANNOT** backdate your list if you find a new NP after the 45th day.



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Forward Exchange Rules

■ 180-Day Rule:

- Must close on purchase of new property within 180 **calendar** days of closing sale of old property.
 - If 180th day falls on weekend or holiday, don't get an extension.
- Must report 1031 exchange on tax return for same year you sell OP.
 - If tax return is due before end of 180 days, **MUST** extend tax return until NP purchased.



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Forward Exchange Rules

■ Constructive Receipt Rule:

- You cannot exercise control over the money between sale of old property and purchase of new property.
 - Proceeds must go directly from closer to QI and directly from QI to closer for NP.
 - If taxpayer controls money at all, exchange fails
- **Need to get attorney and QI selected and involved early.**



Reverse Exchange



- Opposite of forward exchange.
- Purchase new property **first**, then sell old property.
 - Title to NP goes into QI and held until closing for OP.
 - 45 days to identify OP to use in exchange for NP.
 - 180 days to sell OP and take title to NP from QI.



Other types of Exchanges

- **Consolidation Exchange**
 - multiple OP's exchanged for 1 NP
- **Diversification Exchange**
 - 1 OP exchanged for multiple NPs
- **Construction Exchange**
 - Proceeds from OP used to purchase NP and construct building on NP
- **Improvement Exchange**
 - Proceeds from OP used to purchase NP and pay for improvements to NP



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Real Estate Issues



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Common Real Estate Issues

- Name on deed for NP has to be the same as name on the deed for OP.
- Tenants in common, partnerships, single-member LLCs.
- Earnest money.
- Closing costs.



Name on deed for NP must match name on deed for OP

- Can't sell OP held by ACME, Inc., and purchase NP in name of Enrique Iglesias.
- Can't sell OP held by Donald and Melania Trump as joint tenants and purchase NP in name of just Melania Trump.
 - Must have both husband and wife on title for NP.



- What if Donald owns OP by himself and wants Melania on title for NP?
 - Donald owns a skyscraper worth \$1 million in his name only, but wants to exchange it for a white house worth \$1.5 million for use in his business with Melania.
 - Can't put Melania on title for OP unless wait a year and a day.
 - **Donald must take title to undivided 2/3 of NP and Melania take title to other 1/3.**
- What if OP and NP are both worth \$1 million?
 - **Donald must take title to NP and then add Melania to title later.**



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Tenants in Common



- Multiple separate owners.
 - Curly, Larry, and Moe each own 1/3 of comedy club worth \$300,000 and are selling it.
 - All 3 can do exchange with their 1/3.
 - Curly buys new property A.
 - Larry buys new property B.
 - Moe buys new Property C.
 - Or one can do exchange; others can take cash.
 - Will pay tax on cash (of course) .



Partnerships



- What if Curly, Larry, and Moe own the comedy club under CLM partnership?
 - Can Curly take his \$100k from OP and buy new property A in his own name? **NO.**
 - Can they each take \$100k and do own exchange?
 - If dissolve partnership before exchange, they become tenants in common—but must wait year and a day
 - If dissolve partnership after exchange, must do exchange for three NPs in CLM partnership and then dissolve and distribute.



Partnerships

- What if Moe wants to cash out?
 - Curly and Larry can buy his partnership interest and do the exchange for \$300k or more in the name of the partnership.
- OR**
- Partnership can give Moe a quitclaim deed for 1/3 of the comedy club, then partnership can do exchange for \$200k or more.
- Moe will pay tax either way.



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Single Member LLCs



- Exception to identical ownership rule:
 - Assume Alan is the sole member of One Man Wolf Pack, LLC.
 - If Alan owns the OP under his name, can he do an exchange where One Man Wolf Pack, LLC, takes title to NP?
 - Yes, entity disregarded for tax purposes, but provides liability protection for Alan.



Earnest Money

- Alan is selling OP for \$100k.
 - If \$5k earnest money (EM) for OP is paid directly to him instead of QI, is exchange blown?
 - **Depends:**
 - Alan **MUST** bring EM to closing for entire \$100k to go into exchange.
 - If Alan doesn't bring EM to closing, will pay tax on at least \$5k.
 - If exchange agreement doesn't say that Alan is doing an exchange for 95% of the property, will pay tax on **ENTIRE \$100k**.
- **Get the attorney and QI involved early.**



Closing Costs

- How do closing costs and mortgages affect exchangeable amount in a 1031 exchange?
 - Debt paid off is taxable and exchangeable.
 - Mortgage payoff treated same as receiving cash.
 - Closing costs are excluded from exchangeable amount.
 - **Exchangeable amount = net selling price (sales price minus closing costs).**



Closing Costs

- Sales price \$100,000.
- Mortgage payoff \$50,000.
- Closing costs \$10,000.
 - \$100k - \$10k = \$90k (exchangeable amount).
 - **NP must be \$90k or more or will pay tax on shortfall.**
- If NP costs \$85k, will pay tax on \$5k.



Closing Costs

- What about property taxes?
 - Most closing costs are considered “exchange expenses” so there is no tax liability for paying them at closing.
 - Broker’s commissions.
 - Exchange fees.
 - Recording charges.
 - Closing attorney fees.
 - Non-exchange expenses are expenses that are taxable.
 - Loan costs and fees.
 - Insurance premiums.
 - Property taxes.
 - But property taxes are also deductible.
 - **Even though prorated taxes are taxed as income at sale of OP, deduction and income offset each other.**
- Can pay prorated property taxes outside of closing to avoid income and increase exchangeable amount, while still deducting them on tax return.



Common Pitfalls

- Treating 45-day rule as suggestion.
 - 45-day rule is set in stone.
 - Can't bust it for any reason.
 - IRS has chosen not to enforce rule in rare cases (hurricane, terrorist attack, etc.), but don't rely on that.
 - **Cannot** edit list after 45th day at midnight.
 - Negligence penalty, fraud penalty, and criminal charges for providing false documents to IRS.



Common Pitfalls

- Identifying more than three NPs on 45-day list.
 - If three NPs or less, no limit on what you can acquire.
 - While more than three is allowed, it complicates things:
 - Total purchase price of NPs can't exceed 200% of OP, unless you acquire 95% of NPs on list.
 - Sell OP for \$100,000 and list four NPs, the total value of the NPs cannot exceed \$200,000 (unless you buy all of them).



Common Pitfalls

- Taking title to NP under different name from OP.
 - Easy to do in case of partnerships, married couples, etc.
 - Again, easy to avoid if you plan ahead.



Common Pitfalls

- Constructive receipt of proceeds.
 - Once you exercise control over the funds, your exchange is toast.
 - Don't take a check from the closer; don't let anyone wire funds into your account; don't even look at a check with your name on it
 - If you receive earnest money on OP, bring it to closing.



Common Pitfalls

- Getting attorney and QI involved too late.
 - If you just closed on the OP, not the time to decide to do a 1031 exchange.
 - Lots of tricky things can happen with ownership, earnest money, etc.
 - Need to plan ahead.



Attorney's Role

- We help taxpayers by—
 - Finding and coordinating with a qualified intermediary.
 - Drafting exchange agreement.
 - Drafting assignments of contract to QI for OP and NP, and corresponding consents.
 - Drafting the 45-day list.
 - Identifying and fixing issues with ownership.



Questions?

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