



1031 Like-Kind Exchanges

**Commercial Real Estate Hot Spots:
1031 Like-Kind Exchanges
Presentation to the Columbia
Society of Appraisers**

January 28, 2008

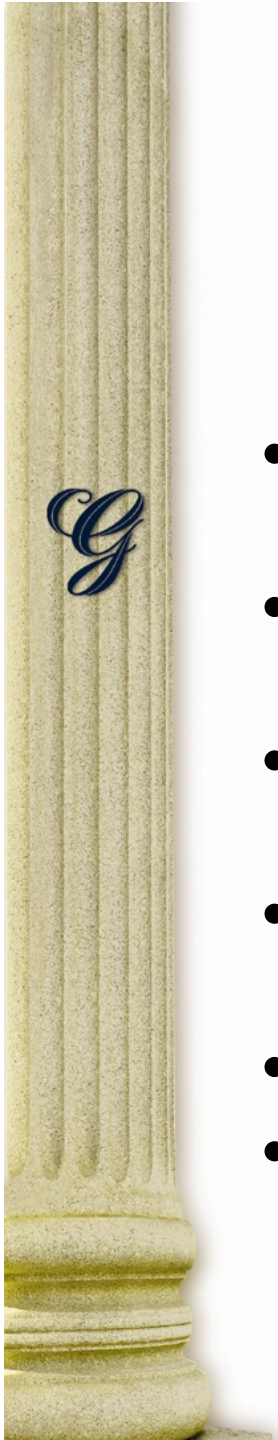
Presented by:


**Jed P. Dallek, CPA, MST
Tax Partner
Grassi & Co., CPAs, P.C.**

Your Presenter

Jed Dallek, Tax Partner, Grassi & Co. CPAs

- **Leading regional CPA firm to the real estate/construction industry**
- **Full service tax, accounting and consulting services**
- **Big enough to get the job done; small enough to care**
- **20+ years of progressive experience in real estate taxation matters**
- **Experience in all aspects of the real estate arena**
- **Strong relationships across real estate industry**



A decorative vertical column with a fluted texture and a blue stylized 'G' logo is positioned on the left side of the slide.

Internal Revenue Code §1031

Non-Recognition of Gain or Loss from Exchange Solely of Kind

“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.”



§1031: Exceptions

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

A decorative vertical column with a blue 'G' logo. The column is light-colored with vertical fluting and a base. The letter 'G' is a stylized, blue, cursive font.

G

“Like-Kind” Property Issues

Definition of “Like-Kind” Properties

Real Property for Real Property

G





Stock in Trade/Dealer Property Issues

- Like-kind refers to the nature or character of the property, not its grade or quality
- The taxpayer's intent must be to hold the relinquished and the replacement property for investment, or for productive use in a trade or business
- Foreign real property is not like-kind to U.S. real property

A decorative vertical column with a fluted texture and a blue stylized 'G' logo is positioned on the left side of the slide.

Partnership Issues

- The basic rule: Partnership interests cannot be exchanged under Section 1031 (Treas. Reg. 1.1031(a)(2)(D))
- The IRS is not bound by state statutes in determining whether or not ownership is a partnership (what is the implied and stated intent of the parties, do they carry on an independent business operation, do they file partnership tax returns, common name and bank account, records?)

A decorative vertical column with a fluted texture and a blue stylized 'G' logo is positioned on the left side of the slide.

Holding Period Issues

- Time is only one factor
- The Exchanger's intent is the key issue
- First Perspective: 24 months or more
 - In PLR 8429039, the IRS stated that a minimum holding period of two years would be sufficient
- Second Perspective: Minimum of 12 months
 - Straddles two tax filing years
 - Over 12 months qualifies for long-term capital gain treatment
 - Attempt by Congress in 1989 to impose one year holding period (which didn't pass)



Tenant-In-Common Programs/Fractional Ownership



Why Consider TIC Ownership

- Investor wants to capitalize on selling higher appreciated property
- Avoid capital gain taxation
- Lack of inventory for quality real estate
- Management relief



Who Should Consider TIC Ownership

Investors who want to:

- Sell property and avoid current taxation
- Reduce time, effort and stress of locating replacement property
- Own institutional grade commercial property
- Diversify real estate holdings

A decorative vertical column with a fluted texture and a blue stylized 'G' logo is positioned on the left side of the slide.

What Is TIC Ownership of Real Estate?

- The co-ownership of a property
- Each TIC owner owns an undivided fractional interest and receives their proportionate share of net income, tax benefits and appreciation
- Most TIC ownership programs are institutional grade properties
- Although there is no minimum, many TIC ownership programs start at \$200,000 and can accommodate \$10M or more

A decorative vertical column with a fluted texture and a blue stylized 'G' logo is positioned on the left side of the slide.

TIC Ownership and §1031 Exchange

- The challenge: Finding replacement property within 45 days
- A properly structured TIC ownership program can be an acceptable replacement property in a §1031 exchange
- Provides a pre-packaged §1031 exchange replacement property solution
- Sell an individually owned property with \$500,000 in equity and purchase a fractional interest in a much larger TIC ownership property with \$500,000 in equity
- “Real Estate by the slice”

TIC Ownership and §1031 Exchange





§1031 Formats and Variations

The Two-Party Trade (Swap)



Party A

Party B

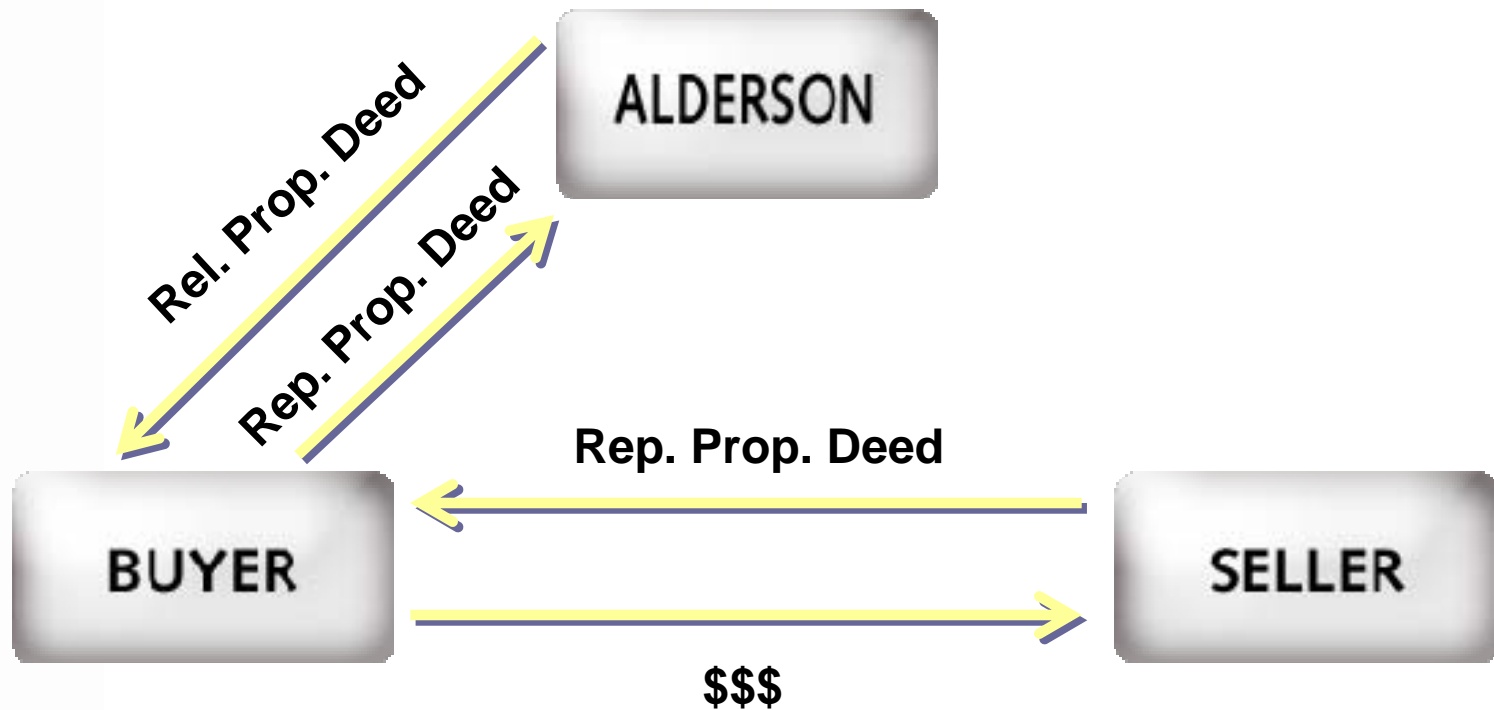
**SINGLE
FAMILY HOME**

**SINGLE
FAMILY HOME**



Trade of Deeds

The Three Party Exchange - Alderson



G

A decorative vertical column with a fluted texture and a blue stylized 'G' logo is positioned on the left side of the slide.

Delayed Exchange Time Requirements

45 Day Exchange 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.



Delayed Exchange

- No Extension for weekends or holidays
- Time limits begin to run on the earlier of the date the taxpayer transfers the benefits or burdens of ownership of the first relinquished property to a buyer, or recording a deed evidencing a transfer, whichever occurs first.
- Both the 45th and 180th day begin to run on the date of the first sale. (It is not 45 days and then 180 days.)

A decorative vertical column with a fluted texture and a blue stylized 'G' logo is positioned on the left side of the slide.

Delayed Exchange Identification Rules

- Three 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 above rules, then the taxpayer must acquire 95% of the value of all properties identified.

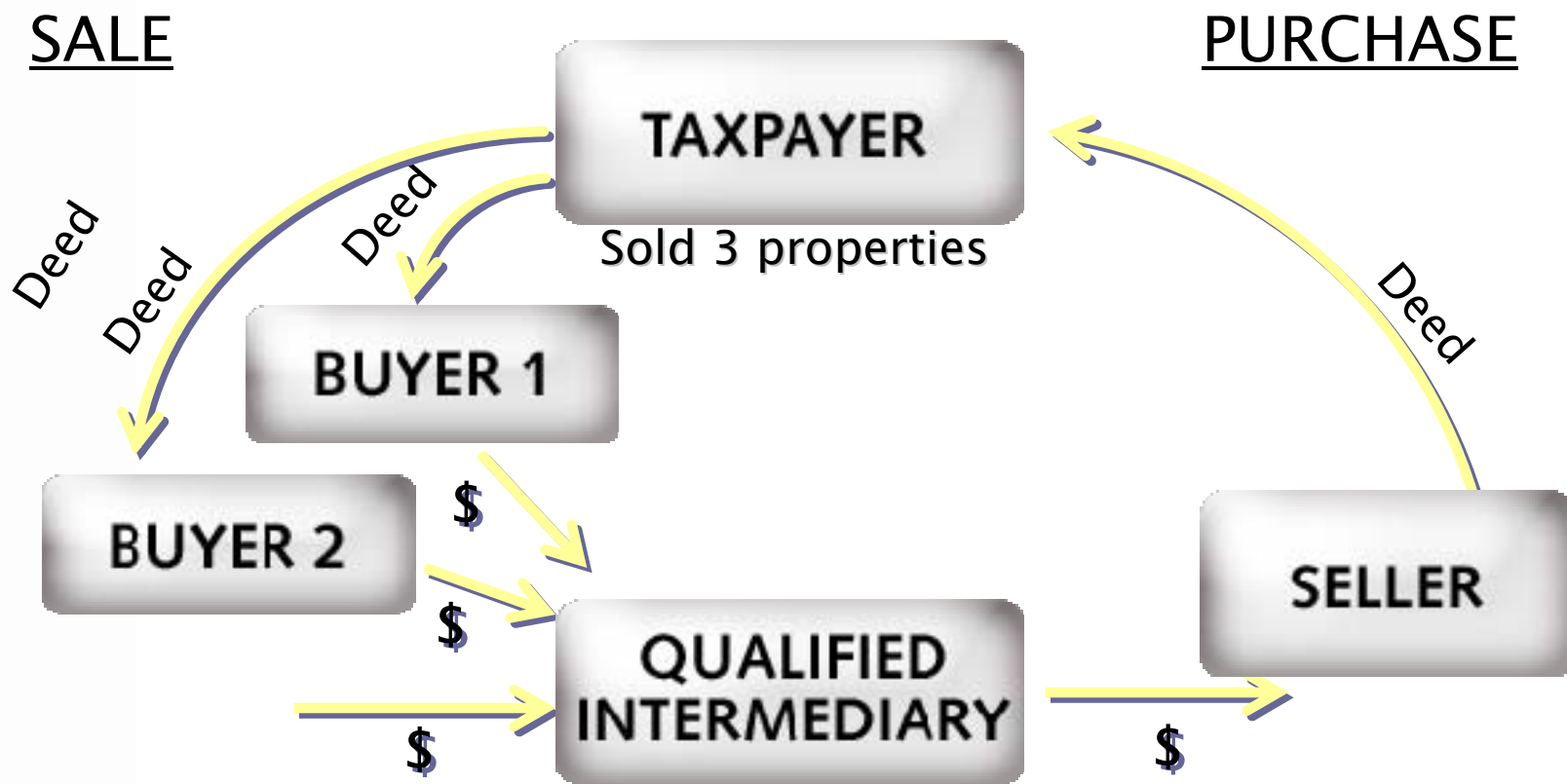
A decorative vertical column with a fluted texture and a blue stylized 'G' logo is positioned on the left side of the slide.

Delayed Exchange Identification Rules

Identification must be:

- Made in writing
- Unambiguously describe the property (street address or legal description)
- Signed and dated by the exchanger
- Received by midnight of the 45th day
- Delivered to the Qualified Intermediary or a party related to the exchange who is not a disqualified person

The Multiple Property Exchange



0 Identification Period 45

Total Exchange Period

180

“Parking Arrangements”

What is a Reverse Exchange?

- Purchasing the replacement property before the sale of the relinquished property



A decorative vertical column with a fluted texture and a blue stylized 'G' logo is positioned on the left side of the slide.

Background of Reverse Exchanges

What Won't Qualify

- The “pure” reverse exchange - taxpayer acquiring title to the replacement property and holding title to the relinquished property at the same time.

A decorative vertical column with a fluted texture and a blue stylized 'G' logo is positioned on the left side of the slide.

Background of Reverse Exchanges

A Concern – “Constructive Ownership”

One of the main concerns is the problem of “constructive ownership.” Taxpayers had to be concerned with the burdens and benefits of ownership versus bare legal title. If only legal title was “parked,” the structure could collapse because the taxpayer could be treated as owning both properties at the same time.

A decorative vertical column with a fluted texture and a blue stylized 'G' logo is positioned on the left side of the slide.

The Improvement Exchange

What is an Improvement Exchange?

Building a new replacement property from the ground-up or making improvements to an existing replacement property.

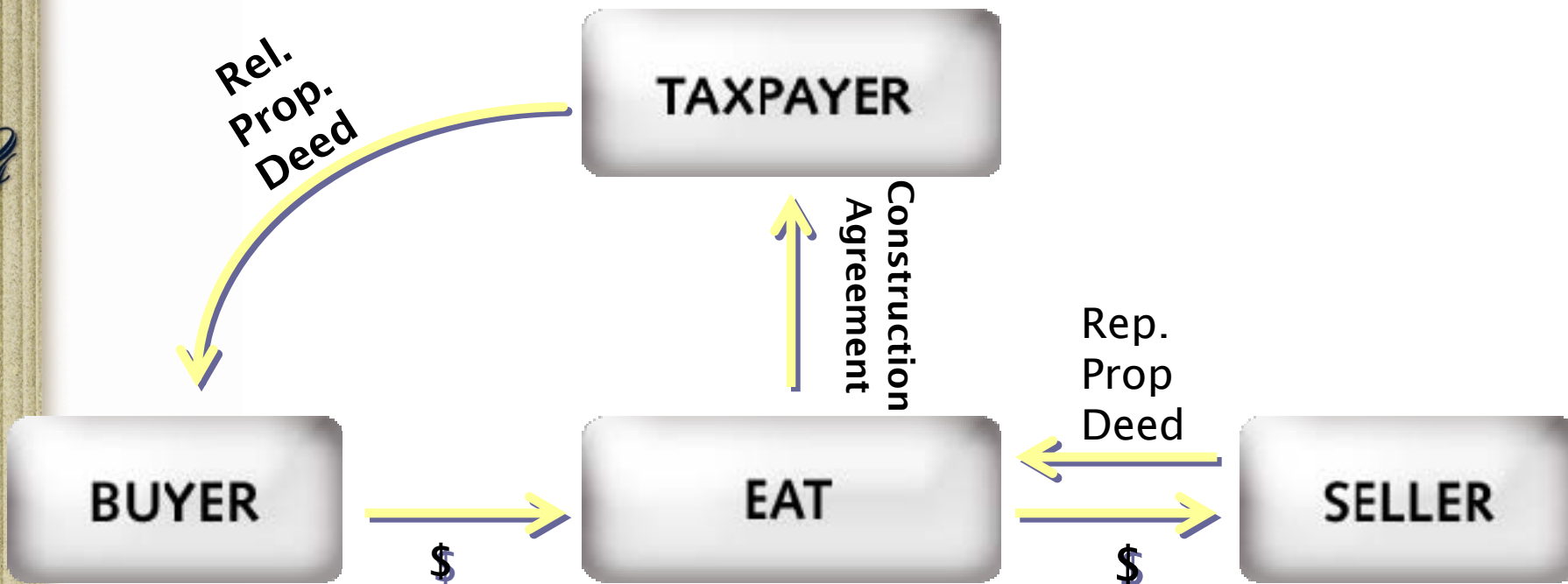
A decorative vertical column with a fluted texture and a blue stylized 'G' logo is positioned on the left side of the slide.

The Improvement Exchange

Why Perform an Improvement Exchange?

- The property to be acquired in the exchange is not of equal or greater value to property being sold
- Build a new investment from ground-up
- The new investment is of equal for greater value but it needs refurbishments

The Improvement Exchange



180

Total Exchange Period

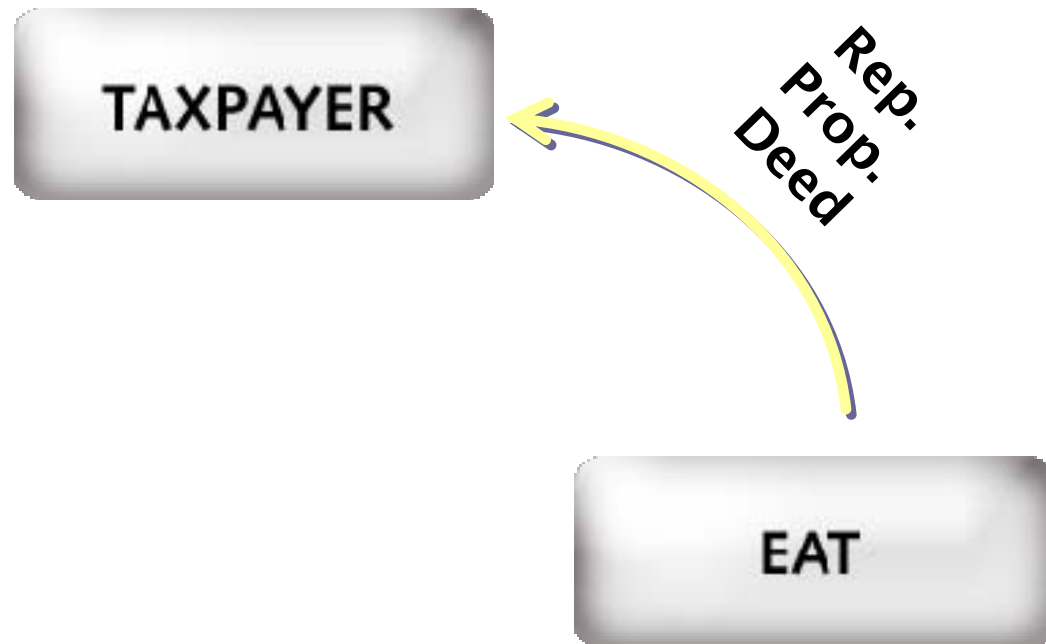
45

Identification Period

0

The Improvement Exchange

Step 2



180

Total Exchange Period

45

Identification
Period

0

The Improvement Exchange

How do the Numbers Work Out?



<u>Relinquished Property</u>	
Sales Price	\$1,000,00
Debt	\$0
Cost of Sale	\$70,000
Net Equity to QI	\$930,000

<u>Replacement Property</u>	
Lot Purchase (cash purchase)	\$600,000
Draw 1 site work	\$100,000
Draw 2 foundation	\$230,000
Exchange Value	\$930,000

A decorative vertical column with a fluted texture and a blue stylized 'G' logo is positioned on the left side of the slide.

Building on Property Already Owned

- The most conservative approach is to not build on land owned by the taxpayer
- PLR 200251008 (September 11, 2002) This ruling approves an exchange structure that taxpayers may use to perform an improvement exchange on land already owned by an affiliate or related party to the taxpayer. The structure involves an affiliate of the taxpayer acting as owner of the property to be improved and leasing it to an EAT. This ruling is case specific and taxpayers should proceed with caution and good legal counsel.

A decorative vertical column with a fluted texture is positioned on the left side of the slide. A blue, stylized letter 'G' logo is placed on the column, approximately halfway down.

Building on Property Already Owned

1. Taxpayer enters into a Qualified Exchange Accommodation Agreement (QEAA) with the EAT and enters into an exchange agreement with a QI;
2. Taxpayer's affiliate or related party leases the replacement property to EAT at fair market rent, for a term of not less than 30 years, as part of the QEAA as defined in Revenue Procedure 2000-37;
3. Taxpayer (or a third-party bank) lends EAT the funds needed to construct improvements on the leased property;
4. Taxpayer assigns its rights to the sale contract of the relinquished property to the QI;

A decorative vertical column with a fluted texture and a blue stylized 'G' logo is positioned on the left side of the slide.

Building on Property Already Owned

5. Taxpayer transfers title to the relinquished property to the buyer;
6. Taxpayer assigns its rights in the QEAA to the QI;
7. QI uses proceeds from the sale of the relinquished property to pay EAT;
8. EAT uses the proceeds received from the QI to pay for improvements and/or to pay the construction loan in full; and
9. QI directs EAT to transfer improved replacement property to taxpayer.



The Exchange Equation

The Exchange Equation

For full tax deferral, a Taxpayer must meet two requirements:

- 1) Reinvest all net exchange proceeds
- 2) Acquire property with the same or greater debt.

	Relinquished	Replacement	Boot
Value	\$900,000	\$1,200,000	
- Debt	\$300,000	\$660,000	\$ 0
- Cost of Sale	\$60,000		
Net Equity	\$540,000	\$540,000	\$ 0

The Taxpayer acquired property of greater value, reinvesting all net equity and increasing the debt on the replacement property.

Analysis: There is no boot.



The Exchange Equation

	Relinquished	Replacement	Boot
Value	\$900,000	\$700,000	
- Debt	\$300,000	\$260,000	\$40,000
- Cost of Sale	\$60,000		
Net Equity	\$540,000	\$440,000	\$ 100,000
Total Boot			\$140,000

The Taxpayer acquired property of a lower value, keeps \$100,000 of the net equity and acquired a replacement property with \$40,000 less debt.

Analysis: This results in a total of \$140,000 in boot.
(\$40,000 mortgage boot and \$100,000 in cash boot = \$140,000)

The Exchange Equation

	Relinquished	Replacement	Boot
Value	\$900,000	\$800,000	
- Debt	\$300,000	\$260,000	<i>\$40,000</i>
- Cost of Sale	\$60,000		
Net Equity	\$540,000	\$540,000	<i>\$ 0</i>
Total Boot			<i>\$40,000</i>

The Taxpayer acquired property of a lower value, reinvesting all net equity, but has less debt on the replacement property.

Analysis: This results in \$40,000 in mortgage boot.

Why Exchange?

Sale vs. an Exchange



1ST CALCULATE NET ADJUSTED BASIS	
Original Purchase Price (Basis)	\$500,000
plus Capital Improvement	\$50,000
less Depreciation	-\$150,000
equals Net Adjusted Basis	\$400,000
2nd CALCULATE CAPITAL GAIN*	
Sales Price	\$1,200,000
less Net Adjusted Basis	-\$400,000
less Cost of Sale	-\$80,000
equals CAPITAL GAIN	\$720,000
3rd CALCULATE CAPITAL GAIN TAX DUE	
Recaptured Depreciation (25%)	\$37,500
plus Federal Capital Gain (15%)	\$85,500
plus State Tax (CA 9.3%)	\$66,960
TOTAL TAX DUE	\$189,960

Why Exchange? Sale vs. an Exchange



4th CALCULATE AFTER-TAX EQUITY	
Sales Price	\$1,200,000
Less Cost of Sale	-\$80,000
Less Loan Balances	-\$300,000
equals GROSS EQUITY	\$820,000
<hr/>	
minus Capital Gain Taxes Due	\$189,960
equals AFTER-TAX EQUITY	\$630,040
<hr/>	
5th ANALYZE REINVESTMENT - SALE	
After-Tax Equity x 4	\$2,520,160
<hr/>	
6th ANALYZE REINVESTMENT – EXCHANGE	
Gross Equity = Net Equity	\$820,000
Gross Equity x 4	\$3,280,000

Note: 25% x \$150,000 = \$37,500 * 15% x \$570,000 = \$85,500 * 9.3% x 720,000 = \$66,960



Refinancing Issues

- **The timing is important;**
- **Consult with advisors;**
- **Post exchange refinancing;**
- **Use refinanced proceeds to pay bills or invest in stocks.**

A decorative vertical column with a fluted texture and a blue stylized 'G' logo is positioned on the left side of the slide.

Exchange Expenses

a) A direct cost of selling real property, which typically includes:

- Real Estate commissions
- Title insurance premiums
- Closing or escrow fees
- Legal fees
- Transfer taxes and Notary fees
- Recording fees

-or-

b) Costs specifically related to the fact the transaction is an exchange such as the Qualified Intermediary fees.



Non-Exchange Expenses

- **Mortgage points and assumptions fees**
- **Credit reports**
- **Lender's title insurance**
- **Prorated mortgage insurance**
- **Loan fees and loan application fees**
- **Property taxes**
- **Utility charges**
- **Association fees**
- **Hazard insurance**
- **Credits for lease deposits**
- **Prepaid rents and security deposits**

QUESTIONS?

Jed P. Dallek, CPA, MST
Tax Partner

(516) 336-2430

jdallek@grassicpas.com

Grassi & Co., CPAs, P.C.

2001 Marcus Avenue, Suite S-265,
Lake Success, NY 11042

Phone: (516) 256-3500 Fax: (516) 256-3510

The Graybar Building, 420 Lexington Ave., Suite 2620,
New York, NY 10170

www.grassicpas.com

