STAN
1031 EXCHANGE

1031 EXCHANGES

AND THE TAX-SAVING

OPPORTUNITIES

2021

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STAN 1031 EXCHANGE
& Our Qualifications

EXPERIENCE: With extensive experience, STAN 1031 has been providing Escrow and Intermediary services since 2013. As a leader in exchange technology, strategies, and solutions, we have successfully participated in numerous exchanges. Our services include, at no extra cost, comprehensive consultation on exchange structure and requirements, as well as support throughout the entire exchange process.

SECURITY: For maximum security and peace of mind, we maintain a Trust Account and carry professional liability insurance. Client exchange proceeds are securely held in a Trust Account at City National Bank in Newport Beach, California.

COSTS: Our fees are competitive and transparent.

- We offer straightforward, flat-rate fees with no hidden costs.
- A rebate is available based on proceeds deposited.
- Our fee covers assistance throughout every step of the exchange process.

We specialize in handling complex exchanges, including deferred, reverse, and improvement exchanges. For reverse and improvement exchanges, we can take temporary title to the Replacement Property through one of our single-asset subsidiary LLCs. We are also well-versed in reverse and improvement exchange financing and can guide clients through available options.

SCOPE OF SERVICE:

• Providing nationwide service with expertise in exchanges across all states. • Handling exchanges from a few thousand dollars to multi-million dollar transactions. • Facilitating multi-asset exchanges.

We collaborate closely with our clients' Realtors, lenders, and settlement agents, offering comprehensive exchange support. Realtors working with STAN 1031 can feel confident that their clients are receiving expert assistance. We also work directly with settlement agents to ensure all closing documents are completed in compliance with 1031 exchange requirements.

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We partner with clients' accountants, attorneys, and financial advisors, providing necessary documents for tax-deferred exchange reporting. Additionally, we are available, at no extra cost, to consult with advisors on strategy or any questions regarding the like-kind exchange process.

CLIENT SATISFACTION: At STAN 1031, the Client is our top priority. We are committed to delivering the highest standards of ethics, competence, friendliness, and professionalism, and we pride ourselves on meeting the expectations of clients who seek nothing less.

Please feel free to call us at (888) 863-2820 with any questions:

Jin Lee - Senior Vice President

DISCLAIMER

This Exchange Manual serves as a basic guide for taxpayers to better understand the potential tax-saving opportunities available under Section 1031 of the Internal Revenue Code. It is not intended to replace professional tax advice or be a definitive reference for the current Internal Revenue Code. Taxpayers are encouraged to consult with their CPA or attorney for guidance on executing a 1031 Exchange, calculating any tax liabilities, and preparing tax returns.

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1031 Exchanges and the Tax-Saving Opportunities

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Section 1: Introduction to 1031 Exchanges

A 1031 Exchange (Tax-Deferred Exchange) is one of the most effective tax deferral strategies available to taxpayers. Section 1031 of the Internal Revenue Code provides the framework for tax-deferred exchanges. Taxpayers should not have to pay income taxes on the sale of property if they intend to reinvest the proceeds into similar or like-kind property. Professionals who advise or counsel real estate investors, such as Realtors, attorneys, accountants, financial planners, tax advisors, escrow agents, closing agents, and lenders, must be familiar with tax-deferred exchanges.

The primary advantage of a 1031 Exchange is that it allows a taxpayer to sell income, investment, or business property and replace it with like-kind Replacement Property without incurring federal or state income taxes on the transaction. A straightforward sale of property and subsequent purchase of Replacement Property does not qualify; an actual Exchange must occur.

However, there are disadvantages to a Section 1031 Exchange, including a reduced depreciation basis for the Replacement Property. The tax basis of the Replacement Property is essentially the purchase price minus the gain that was deferred on the sale of the Relinquished Property through the exchange. This means the Replacement Property includes a deferred gain, which will be taxable in the future if the taxpayer cashes out of the investment.

Exchange Methods: There are several ways to structure a tax-deferred exchange under Section 1031 of the Internal Revenue Code. The 1991 "safe harbor" Regulations provided specific procedures, such as using an Intermediary, direct deeding, and qualified escrow accounts for temporarily holding "exchange funds." These procedures are IRS-approved and help ensure compliance. As a result, exchanges are often structured to align with these regulations, and the services of a Qualified Intermediary are commonly employed.

While exchanges can occur without an Intermediary if the parties are willing to exchange deeds or enter into an Exchange Agreement, two-party exchanges are rare. In most Section 1031 transactions, the seller of the Replacement Property is not the buyer of the taxpayer's Relinquished Property.

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Section 2: The Basic Rules For A 1031 Exchange

The Relinquished Property Must Be Qualifying Property:
Qualifying property includes property held for investment purposes or used in a taxpayer's trade or business. Investment property refers to real estate, whether improved or unimproved, held for investment or income-producing purposes. Property used in a trade or business includes office facilities or other places where business activities are conducted. Real estate must be replaced with like-kind real estate.

Non-Qualifying Property for a 1031 Exchange Includes:

A personal residence	Land being developed for resale
Properties being constructed or renovated for resale (fix-and-flips)	
Property bought or held for resale	Inventory property
Corporate stock	Partnership interests
LLC membership interests	Bonds
Notes	

The Replacement Property Title Must Be Held in the Same Name as the Relinquished Property:
If the property was owned by a husband and wife in joint tenancy or as tenants in common, the Replacement Property must be deeded to both spouses in the same manner, either as joint tenants or tenants in common. For corporations, partnerships, LLCs, and trusts, the title of the Replacement Property must match the title of the Relinquished Property.

The Replacement Property Must Be Like-Kind:
In real estate exchanges, like-kind Replacement Property refers to any real estate, improved or unimproved, held for income, investment, or business use. For example:
Improved real estate can be exchanged for unimproved real estate.
Unimproved real estate can be exchanged for improved real estate.
A 100% interest in a property can be exchanged for an undivided percentage interest with multiple owners, and vice versa.

One property can be exchanged for two or more properties, and two or more properties can be exchanged for a single Replacement Property.
A duplex can be exchanged for a four-plex.
Investment property can be exchanged for business property and vice versa.

As mentioned earlier, a taxpayer’s personal residence cannot be exchanged for income property, and income or investment property cannot be exchanged for a personal residence intended for the taxpayer’s own use. For further clarification, see the expanded explanation below regarding various real estate interests that qualify as like-kind for real estate exchanges.

Any Boot Received In Addition To Like-kind Replacement Property Will Be Taxable (to the extent of gain realized on the exchange). This is okay when a seller desires some cash or debt reduction and is willing to pay some taxes. Otherwise, boot should be avoided in order for a 1031 Exchange to be completely tax free.

The term "boot" is not used in the Internal Revenue Code or the Regulations but is commonly used in discussing the tax consequences of a Section 1031 tax-deferred exchange. Boot received is the money, debt relief or the fair market value of "other property" received by the taxpayer in an exchange. Money includes all cash equivalents received by the taxpayer. Debt relief is any net debt reduction which occurs as a result of the exchange taking into account the debt on the Relinquished Property and the Replacement Property. "Other property" is property that is non-like-kind, such as personal property received in an exchange of real property, property used for personal purposes, or "non-qualified property." "Other property" also includes such things as a promissory note received from a buyer (Seller Financing).

A Rule Of Thumb for avoiding "boot" is to always replace with property of equal or greater value than the Relinquished Property. Never "trade down." Trading down always results in boot received, either cash, debt reduction or both. Boot received is mitigated by exchange expenses paid. See *The Rules Of Boot In A Section 1031 Exchange* (below) for a detailed explanation of these rules.

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Section 3: Real Estate Interests Which Are Like-Kind

The following types of real estate interests are deemed by Congress and the IRS to qualify as like-kind to each other for a 1031 Exchange –

- Water rights
- Mineral Rights
- Fee interest
- Fractional (tenancy-in-common) interest
- Leasehold interest, 30-year plus lease
- Oil & Gas interests
- Transferrable Development Rights
- Mutual Irrigation Ditch Stock
- Easements for conservation
- Easements for right of way

Section 4: The Basic Types of Exchanges

A **Simultaneous Exchange** occurs when the closings of both the Relinquished Property and the Replacement Property happen on the same day, typically back-to-back, with no time gap between the two. This type of exchange is covered by the Safe Harbor Regulations.

A **Delayed Exchange** is an exchange where the Replacement Property is acquired after the closing of the sale of the Relinquished Property. In this case, the exchange is not simultaneous. This type of exchange is sometimes referred to as a "Starker Exchange," named after the well-known Supreme Court case that ruled in favor of a delayed exchange before such exchanges were provided for in the Internal Revenue Code. The Code and Regulations establish strict time frames for completing a delayed exchange, including the 45-Day Clock and the 180-Day Clock (see detailed explanation below).

A **Reverse Exchange** (also known as a Title-Holding Exchange) involves acquiring the Replacement Property before the Relinquished Property is sold. Typically, the Intermediary takes title to the Replacement Property and holds it until the taxpayer can sell the Relinquished Property and close the sale under an Exchange Agreement with the Intermediary. After the sale of the Relinquished Property (or simultaneously with the sale), the Intermediary transfers the title of the Replacement Property to the taxpayer. The IRS has issued safe harbor guidance for Reverse Exchanges (see below).

An **Improvement Exchange** (also a Title-Holding Exchange) is used when a taxpayer wants to acquire a property and make improvements on it before it is received as Replacement Property. These improvements are often a building constructed on an unimproved lot, but can also include enhancements to an already improved property to increase its value enough to complete the Exchange without triggering boot. The Code and Regulations do not account for improvements made after the closing of the Replacement Property. Therefore, the Intermediary must take title to the property, hold it until the improvements are completed, and then transfer the title of the improved property to the taxpayer as Replacement Property. Improvement Exchanges can be part of either Delayed or Reverse Exchanges, depending on the situation. The IRS has issued safe harbor guidance for Reverse Exchanges, including those involving title-holding for construction or improvements.

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Section 5: The "Held For" Requirement for 1031 Property Received or Exchanged

To qualify for a 1031 Exchange, both the Relinquished and Replacement Properties must have been acquired and "held for" investment purposes or for use in a trade or business. However, the Code and Regulations do not specify the exact duration that the property must be "held for" such purposes.
According to the IRS, if a taxpayer acquires property right before an exchange or disposes of the Replacement Property shortly after an exchange, it may be considered that the property was not "held for" the required purpose, and therefore the "held for" requirement would not be satisfied.

There is no safe harbor holding period for complying with the "held for" requirement. The IRS interprets compliance based on their view of the taxpayer's intent. Intent is demonstrated by facts and circumstances surrounding the taxpayer's acquisition of ownership of the property and what the taxpayer does with the property. The courts have been more liberal than the IRS on these issues.

Here are some examples of transactions that could lead the IRS to determine that the "held for" requirement has not been satisfied:

- The taxpayer acquires Replacement Property and immediately lists it for sale. The IRS is likely to view this as an intent to resell the property rather than holding it for investment purposes.
- The taxpayer receives the Relinquished Property by deed from a partnership and promptly sells or exchanges it (referred to as a "drop and swap").
- The taxpayer acquires Replacement Property and immediately converts it into a personal residence.
- The taxpayer acquires Replacement Property and quickly transfers it to a corporation, partnership, or LLC.

To minimize the risk of issues with the "held for" requirement, it is advisable to allow some time between these actions. Exchange professionals typically recommend holding the Replacement Property for at least one year. In a private letter ruling (Ltr Rul 8429039), the IRS determined that a two-year holding period was sufficient, but this was not made a formal requirement. Ultimately, it is the taxpayer's responsibility to demonstrate compliance with the "held for productive use in investment or a trade or business" requirement.

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Section 6: Delayed Exchanges – The Exchange Process And Time Clocks

A taxpayer wishing to complete a 1031 Exchange lists and/or markets the property for sale in the usual manner, without considering the potential 1031 Exchange at this stage. Once a buyer is found, a contract for the sale is signed. While accommodation language is often added to the contract to secure the buyer's cooperation with the taxpayer's 1031 Exchange, this is not a mandatory requirement.

Once contingencies are met and the contract is ready to close, the services of an Intermediary are arranged. The taxpayer then enters into an Exchange Agreement with the Intermediary, allowing the Intermediary to act as the "substitute seller" according to the regulations set forth in the Code and Regulations.

The Exchange Agreement typically outlines:

- An assignment of the seller's Contract to Buy and Sell Real Estate to the Intermediary.
- A closing in which the Intermediary receives the proceeds due to the seller, with direct deeding used. The Agreement ensures that the taxpayer has no right to the funds held by the Intermediary until the exchange is completed or the Agreement ends.
- A period during which the seller locates suitable Replacement Property and enters into a contract to purchase it, subject to the 45-Day and 180-Day rules.
- An assignment of the contract to purchase Replacement Property to the Intermediary.
- A closing where the Intermediary uses the exchange funds to acquire the Replacement Property for the seller.

The 45-Day Rule for Identification: The taxpayer must identify potential Replacement Property within 45 days of transferring the Relinquished Property. If a property is received within 45 days, the rule is satisfied. Otherwise, the taxpayer must submit a written identification notice to the Intermediary, containing a clear description of the Replacement Property, including legal descriptions, street addresses, or distinguishing names.

There are three options for identifying Replacement Properties:

- **The Three-Property Rule**: Up to three properties, regardless of their market value.
- **The 200% Rule**: Any number of properties, as long as their total fair market value does not exceed 200% of the value of the exchanged properties.
- **The 95% Rule**: Any number of properties, if the properties received by the end of the exchange period equal at least 95% of the total fair market value of all identified properties.

Although the Regulations only require written notification within 45 days, it is considered best practice to have a solid contract in place by the end of the 45-day period. Otherwise, the taxpayer may find themselves unable to close on any properties identified in the 45-day letter. Once the 45-day period has passed, it is no longer possible to close on properties that were not identified in the 45-day letter.

If the 45-Day Letter is not submitted, the Exchange Agreement will be terminated, and the Intermediary will return all unused funds to the taxpayer.

The 180-Day Rule for Receipt of Replacement Property: The Replacement Property must be received and the exchange completed no later than the earlier of:

- 180 days after the transfer of the exchanged property, or
- The due date (including extensions) of the income tax return for the year in which the Relinquished Property was transferred.

The Replacement Property received must be substantially the same as the property identified under the 45-day rule. There is no provision to extend the 180-day period for any circumstance or hardship, although extensions are allowed for presidentially declared disaster areas.

As mentioned, the 180-Day Rule can be shortened to the tax return due date if no extension is filed. For example, if the Exchange begins late in the year, the 180-day period may extend past the April 15 filing date for tax returns. However, if the Exchange isn't completed by the tax filing deadline, the return must be extended. Failing to do so may result in the exchange period ending on the original tax return due date, which can be a trap for the unaware taxpayer.

Section 7: Reverse Exchanges – The Exchange Process and Time Clocks

Safe Harbor Reverse Exchanges – Rev. Proc. 2000-37, issued by the IRS on September 15, 2000, established guidelines for Reverse Exchanges and provided “safe harbor” protection for exchanges that adhere to these guidelines. These are referred to as “Safe Harbor Reverse Exchanges.” Reverse Exchanges that do not meet the safe harbor guidelines are not prohibited by Rev. Proc. 2000-37, but they must be evaluated on their own merits and are called “Non-Safe Harbor Reverse Exchanges.”

Both types of Reverse Exchanges are commonly used and occur when a taxpayer arranges for an Exchange Accommodation Titleholder (EAT), typically the Intermediary, to temporarily hold title to the Replacement Property before the taxpayer finds a buyer for their Relinquished Property. In some cases, the EAT will also take and hold title to the Relinquished Property until a buyer is found. Reverse Exchanges of either type are particularly useful when a taxpayer needs to close on the Replacement Property before selling the Relinquished Property.

A Reverse Exchange is often used when a taxpayer needs to acquire Replacement Property before selling the Relinquished Property or when they want more time to search for suitable Replacement Property before selling, which would trigger the 45-day and 180-day time limits for Delayed Exchanges. Reverse Exchanges are also common when a taxpayer wants to purchase a property and make improvements on it before taking title as Replacement Property. This approach is necessary when the value of the improvements is critical to replacing the property with one of equal or greater value, avoiding a taxable "trade-down."

Rev. Proc. 2004-51, issued in 2004, added a requirement for Reverse Exchanges to qualify under the safe harbor. Properties owned by the taxpayer within the previous 180 days are not eligible for protection under Rev. Proc. 2000-37.

Safe Harbor Reverse Exchange Time Limits:

- **The Five-Day Rule**: A "Qualified Exchange Accommodation Agreement" must be signed between the taxpayer and the exchange accommodation titleholder (typically the Qualified Intermediary) within five business days after the title is taken by the exchange accommodation titleholder for a Reverse Exchange.
- **The 45-Day Rule**: The taxpayer must identify the Relinquished Property within 45 days. Multiple properties can be identified using rules similar to Delayed Exchanges (e.g., the three-property rule, the 200% rule).
- **The 180-Day Rule**: The Reverse Exchange must be completed within 180 days after the exchange accommodation titleholder takes title.

180-Day Clock: Reverse Exchanges must be completed within 180 days, as with Delayed Exchanges. Before Rev. Proc. 2000-37, there was no time limit for title ownership by the exchange accommodation titleholder, and it was common for the titleholder to hold the property for a year or more. While 180 days might be suitable for finding a buyer for the Relinquished Property, it may not be enough time for larger "build-to-suit" exchanges involving property improvements.

If the taxpayer hasn't found a buyer for the Relinquished Property by the end of 180 days, they may discontinue the Reverse Exchange and take title to the Replacement Property. Alternatively, the taxpayer may extend the exchange outside the safe harbor protections, but this increases audit risk.

Rev. Proc. 2000-37 imposes certain responsibilities on the Exchange Accommodation Titleholder, including reporting the tax attributes of the property they hold. There is uncertainty regarding whether the Accommodator must also report depreciation on the property, as a true owner would.

The taxpayer may choose to extend their Reverse Exchange beyond the protection of the safe harbor procedures. It's important to note that the IRS's safe harbor guidelines are not mandatory. Reverse Exchanges that do not adhere to the requirements of Rev. Proc. 2000-37 are evaluated on their individual merits and may carry a higher risk of being audited.

Rev. Proc. 2000-37 places specific responsibilities on the Exchange Accommodator Titleholder. The Accommodator must report the "tax attributes" of the property they hold title to for federal income tax purposes. This may include reporting any rents and expenses related to the property's ownership. However, it remains unclear whether the Accommodator is required to report depreciation on the property, as a true owner would be obligated to do.

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Section 8: The Role of the Qualified Intermediary

The role of the Qualified Intermediary is crucial to the successful and valid completion of a delayed exchange. This intermediary acts as the connector between the buyer and seller, facilitating the 1031 Exchange process. Even though the intermediary (often called an exchange facilitator) might be considered an agent under state law, they are not deemed the taxpayer's agent for constructive receipt purposes. This distinction ensures that the taxpayer does not have immediate possession of the money or property under the laws of agency.

To qualify for the "safe harbor" protection, a written agreement must exist between the taxpayer and the intermediary, which specifically limits the taxpayer's ability to receive, pledge, borrow, or otherwise access the funds or property held by the intermediary.

A Qualified Intermediary is defined as someone who is neither the taxpayer nor a disqualified person and enters into a written exchange agreement with the taxpayer. The intermediary handles the acquisition of both the Relinquished and Replacement Properties, facilitating their transfer between the taxpayer and the respective buyers. Importantly, the intermediary doesn't need to be in the chain of title.

While there are no specific licensing requirements from the IRS, the intermediary must not be a disqualified person. For instance, accountants, attorneys, and realtors who have worked with the taxpayer in the past two years are disqualified, as are related parties.

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Section 9: Criteria for Selecting a Qualified Intermediary

Intermediaries act as limited-purpose depositories, holding all Exchange Funds during a 1031 Exchange. Consequently, they often manage substantial sums of money on behalf of their clients. However, aside from a few states, such as Nevada, California, Idaho, Colorado, and Arizona, there is no federal or state regulation overseeing Intermediaries. If an intermediary becomes bankrupt or insolvent, taxpayers are treated as unsecured creditors. Funds managed by Intermediaries are typically invested in various ways, including pooled cash funds with stock brokerages or segregated liquid asset money market accounts. Choosing the right Intermediary to manage Exchange Funds is a critical decision.

Intermediaries offer a broad range of services and possess varying levels of professional expertise, with some being tax professionals or Certified Exchange Specialists, while others are attorneys, accountants, or affiliated with banks, title companies, or real estate agencies. Not all intermediaries are experienced in tax matters or 1031 Exchange technicalities, and some may only handle fund management.

Intermediary compensation methods vary. Some charge minimal or no fees, instead retaining a portion of the interest earned on the held funds. Others charge higher fees but pass all interest earned back to the client. The interest rates depend on the types of investments made with the funds.

When choosing an Intermediary, taxpayers should consider several factors:

- Does the Intermediary have prior real estate transaction experience?
- Are the funds held in segregated, FDIC-insured accounts?
- Is the Intermediary willing to consult with you on strategies, issues, and executing documents?
- Are they bonded with a fidelity bond or have a Trust Account?
- Are funds easily accessible?
- Can they manage closings to avoid boot and related taxes that could exceed their fees?

STAN 1031 meets all these expectations.

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Section 10: The Rules of "Boot" In A Section 1031 Exchange

To ensure a Section 1031 exchange is fully tax-deferred, the taxpayer must not receive any "boot." Any boot received is subject to tax based on the gain realized from the exchange. While receiving boot is acceptable when a seller wants some cash and is prepared to pay taxes, it should be avoided for a completely tax-free exchange.

Although the term "boot" is not explicitly used in the Internal Revenue Code or Regulations, it is commonly referenced in discussions about the tax implications of a Section 1031 exchange. Boot refers to money, debt relief, or the fair market value of "other property" received in the exchange. This includes:

- **Money**: Any cash or cash equivalents received by the taxpayer.
- **Debt relief**: Any reduction in debt resulting from the exchange, considering the debt on both the Relinquished Property and the Replacement Property.
- **Other property**: Property that is not like-kind, such as personal property received in a real estate exchange, property for personal use, or "non-qualified property." This category also includes promissory notes (Seller Financing).

Boot can result from various factors, often unintentionally. It's crucial for taxpayers to understand potential sources of boot to avoid taxable income. The most common sources of boot are:

- **Cash boot**: Cash received during the exchange, typically in the form of "net cash received" at closing, either from the Relinquished Property or Replacement Property.
- **Debt reduction boot**: Occurs when the taxpayer's debt on the Replacement Property is lower than the debt on the Relinquished Property. This typically happens if the taxpayer is "trading down" in the exchange.
- **Sale proceeds used for non-closing expenses**: If sale proceeds are used to cover non-transaction costs at closing (e.g., rent prorations, utility escrow charges, tenant damage deposits, property tax prorations), it's treated as if the taxpayer received cash from the exchange and then used it for these costs. To avoid this, taxpayers are advised to bring cash to cover non-transaction costs at the closing of their Relinquished Property, including:
    - Rent prorations
    - Utility escrow charges
    - Tenant damage deposits transferred to the buyer
    - Property tax prorations (see explanation below)
    - Any other non-closing charges

Tax prorations on the Relinquished Property settlement statement may be considered debt service based on PLR 8328011, which suggests that exchange funds used for tax prorations should not result in taxable boot. However, taxpayers might prefer to bring their own cash to the Relinquished Property closing to mitigate this concern.

- **Excess borrowing to acquire Replacement Property**: Borrowing more than necessary to close on the Replacement Property can lead to excess cash being held by the Intermediary, which will be returned to the taxpayer, resulting in cash boot. Taxpayers should ensure that all cash held by the Intermediary is used for the Replacement Property purchase and avoid borrowing more than necessary.
- **Loan acquisition costs**: If loan acquisition costs (such as origination fees) are paid from exchange funds, the IRS may consider this as a distribution from the Exchange Funds, resulting in boot. While taxpayers often claim that these costs are covered by loan proceeds, the IRS may view this differently due to the lack of specific Treasury Regulations on the matter.
- **Non-like-kind property**: If non-like-kind property is received in addition to like-kind property (real estate), it may result in boot. Examples include:
    - Seller financing, such as a promissory note
    - Furniture and fixtures acquired with real estate
    - Equipment (e.g., sprinkler equipment) acquired with farm property

Boot Offset Rules: Only the net boot received by the taxpayer is taxed. To determine the net boot, certain offsets are allowed, while others are not.

- **Cash boot paid offsets cash boot received (but only at the same closing)**: Cash boot paid at the Replacement Property closing cannot offset cash boot received at the Relinquished Property closing (Reg. §1.1031(k)-1(j)(3) Example 2). This likely also applies to inadvertent boot received at the Relinquished Property closing due to prorations or similar factors (as mentioned above).
- **Debt incurred on the Replacement Property offsets debt-reduction boot received on the Relinquished Property**: Any debt incurred for the Replacement Property can offset debt-reduction boot received on the Relinquished Property.
- **Cash boot paid offsets debt-reduction boot received**: Cash boot paid can reduce debt-reduction boot received.
- **Debt boot paid never offsets cash boot received**: Debt boot paid will never offset cash boot received. Net cash boot received is always taxable.
- **Exchange expenses (transaction and closing costs) paid offset net cash boot received**: Transaction and closing costs paid can offset the net cash boot received.

General Guidelines:

- **Always trade "across" or up, never trade down**: Stick to the “even or up rule.” Trading down will always lead to receiving boot (cash, debt reduction, or both). However, paying exchange expenses can help reduce the boot received.
- **Bring cash to the Relinquished Property closing**: Use personal cash to cover charges that are not part of the transaction costs (as listed above).
- **Do not accept non-like-kind property**: If you receive non-like-kind property, ensure it is paid for.
- **Avoid over-financing Replacement Property**: Only finance the amount necessary to close on the Replacement Property, in addition to the exchange funds being used for the purchase.

In California, if the boot is in excess of $1500, the QI is required to withhold 3.33% (0.0333) of the sales price.

Section 11: Related Party Exchanges
(Two-Year Holding Period Requirement)

Exchange of property between related parties: The IRS has specific rules governing exchanges between related parties under IRC §1031(f). For an exchange between related taxpayers to qualify for non-recognition treatment, the exchanged property must be held for at least two years after the exchange. If either party disposes of the property before the two-year period ends, any gain or loss that would have been recognized on the original exchange must be recognized on the date of the disqualifying disposition.

Sale to an unrelated party, replacement from a related party: Taxpayers often wish to sell property to an unrelated party while receiving Replacement Property from a related party. However, this type of transaction is not permitted if the related party receives cash (Rev. Rul. 2002-83). The IRS argues that if a taxpayer or related party "cashes out" of the property, IRC §1031(f)(4) applies, disallowing the exchange. If the related party is also engaged in an exchange and does not "cash out," it is acceptable to receive Replacement Property from them (PLR 200440002 and PLR 200616005).

Sale to a related party, replacement from an unrelated party: It is generally allowed for a taxpayer to sell property to a related party and receive Replacement Property from an unrelated party. There has been some confusion about whether the related party must hold the property it acquires from the taxpayer for two years. Form 8824 instructions seem to imply that the two-year rule applies, but rulings such as PLR 200706001, PLR 200712013, PLR 200728008, and PLR 2010227036 (released between 2007 and 2010) state that the two-year holding requirement does not apply to a related party who purchases the Relinquished Property from the taxpayer.

Related parties under the rules:
The following are considered related parties under IRC §1031(f):

- Family members, including brothers, sisters, half-siblings, spouses, ancestors (parents, grandparents, etc.), and lineal descendants (children, grandchildren, etc.)
- An individual and a corporation when the individual owns more than 50% of the outstanding stock of the corporation, directly or indirectly
- Two corporations that are part of the same controlled group as defined in IRC §1563(a), with "more than 50%" replacing "at least 80%"
- A trust fiduciary and a corporation when the trust or its grantor owns more than 50% of the corporation's stock, directly or indirectly
- Grantors and fiduciaries, and fiduciaries and beneficiaries, of any trust
- Fiduciaries of two different trusts, and fiduciaries and beneficiaries of two trusts, if the same person is the grantor of both
- A tax-exempt educational or charitable organization and any person who controls it, or a member of that person's family
- A corporation and a partnership if more than 50% of both the corporation's stock and the partnership's capital or profits interest is owned by the same people
- Two S corporations if more than 50% of the stock of each corporation is owned by the same people
- A corporation and an S corporation if more than 50% of the stock of each is owned by the same

people
- An estate's executor and the beneficiary, except in the case of a sale or exchange satisfying a pecuniary bequest
- Two partnerships if more than 50% of the capital or profits interest in both is owned by the same people
- A person and a partnership when the person owns more than 50% of the capital or profits interest in the partnership

A disqualifying disposition does not include sales or transfers resulting from the death of either party, the compulsory or involuntary conversion of the exchanged property if the exchange occurred before the threat or likelihood of the conversion, or transfers where it can be proven to the IRS's satisfaction that neither the exchange nor the disposition was primarily intended to avoid federal income tax.

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Section 12: Multiple-Asset Exchanges and Personal Residences

A Multiple-Asset Exchange occurs when a taxpayer is selling or exchanging property that includes more than one type of asset. A typical example is a farm property that includes both a personal residence and farmland.

The Treasury Department has issued regulations outlining how multiple-asset exchanges should be reported. These regulations establish "exchange groups" that must be separately assessed for compliance with like-kind replacement requirements and boot rules. Farmland must be replaced with like-kind real property, while a personal residence is not eligible for 1031 treatment and is handled under the rules for the sale of a personal residence.

The Multiple-Asset Regulations are somewhat unclear on how to account for the personal residence portion of a multiple-asset exchange. However, it is common practice to split the closing of the Relinquished Property into two separate transactions—one for the personal residence and another for the rest of the property. The proceeds from the sale of the personal residence are typically disbursed directly to the taxpayer, rather than being held by the Intermediary in the exchange escrow. The remaining proceeds are retained by the Intermediary to fund the acquisition of qualifying like-kind Replacement Property under the Exchange Agreement.

Another example of a multiple-asset exchange is the sale of real property that includes personal property (such as furniture and appliances). Hotel properties, which often involve both real and personal property, are a good illustration of this type of exchange.

Even a rental property exchange may involve a mix of real and personal property. In practice, the value of personal property transferred with rental property is usually ignored for tax calculation and reporting purposes. However, there is no de minimis rule allowing taxpayers to disregard the value of personal property, even if it is minimal.

The Multiple-Asset Regulations are complex, so it is essential to consult a tax professional for proper analysis and reporting. The tax professional will assist in determining values, allocating the sale price and purchase price to the various parts of the transaction. If the exchange includes personal property of significant value, this should be clearly stated in the contract as non-qualifying property.

Section 13: Partnership and Co-Ownership Issues

Investment real estate is often owned by co-owners in a partnership with two or more partners, or by co-owners as tenants in common. Exchanging a tenant in common interest in real estate typically poses no issues and qualifies for 1031 Exchange treatment. However, exchanging an interest in a partnership is not allowed under the Code and Regulations.

When a partnership owns property and wishes to sell or exchange it, the partnership itself is the Exchanger and a party to the Exchange Agreement. The partnership will take title to the Replacement Property.

It is common for individual partners in a partnership to want to take their share of the proceeds from the sale of partnership property, replace it with qualifying 1031 Replacement Property in their own names, and sever their relationship with the partnership. This situation presents challenges that require careful planning and carries potential tax risks.

If a partnership with two or more partners decides to dissolve, sell the property, and go separate ways—either with cash or through a 1031 Exchange—individual partners must first receive the deed to the property before the sale. This is typically done through a distribution of property from the partnership to the partners, who then hold the property as tenants in common. Each individual partner is then able to sell or exchange their tenancy in common interest. This process is called a “drop and swap” and is often done at the same closing table. However, to meet the "held for investment" requirement, it is advisable for the "drop" to occur well in advance of the "swap." The IRS has challenged simultaneous “drop and swap” transactions in the past, but courts have generally been more lenient.

If a partnership with multiple partners wants to exchange property under the partnership's name, but some partners prefer to "cash out" or go in different directions, a "split-off" is commonly used. The partnership distributes tenancy in common title to a portion of the property to those partners wishing to proceed separately, while the partnership (and its remaining partners) continue with the exchange in the name of the partnership.

The guidance of a tax professional is crucial for effective tax planning and structuring successful exchanges of partnership and co-ownership interests in real estate.

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Section 14: What is a TIC?
(Tenancy In Common Investment)

Tenancy in common (TIC) investments have grown significantly in popularity in the U.S. in recent years. A TIC investment involves a taxpayer co-owning real estate with other investors, where each investor holds a deed to the property as a tenant in common. This type of investment qualifies under the like-kind rules of IRC §1031. TIC investments are commonly made in properties like apartment complexes, shopping centers, and office buildings. Sponsors of TICs organize syndications to meet IRS requirements, such as those outlined in Rev Proc 2002-22, which, among other things, limits the number of investors to 35.

TIC investments appeal to taxpayers who want to move away from managing real estate themselves. These investments offer the potential for stable returns, typically in the 6% to 7% range, with management duties handled by professionals.

The entities that organize TIC investments are known as "sponsors." These sponsors may offer TIC investments directly or through brokers who present a variety of offerings available in the market.

Most TIC investments are considered securities because they meet the definition of securities in the state where the property is located or in the states where the sponsor markets the investment. While the SEC has not made a ruling on this, many states' laws classify TICs as securities. This means that only licensed securities dealers can market them. Despite being treated as securities under state law, TIC investments are still considered real estate for purposes of §1031.

Some sponsors structure their TIC offerings so they are not subject to state securities laws. In such cases, the sponsor is typically not involved in the management of the investment, and an independent management company is hired instead.

TIC investments are usually structured in one of the following ways:

- A single-tenant property with an established credit rating,
- Multiple tenants with a single master lease with the TIC sponsor, who subleases to the tenants,
- Multiple tenants each with separate leases, managed by professional management.

Taxpayers interested in TIC investments should be aware that these are long-term investments with limited liquidity. Like any real estate investment, TICs carry certain business risks. It is crucial to research the track record and management performance of the TIC sponsor and carefully review any available operating statements and prospectuses. Consulting a financial advisor is recommended when necessary.

For a list of TIC sponsors and brokers by state, visit the Tenant In Common Association (TICA) website at www.ticassoc.org.

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Section 15: What is a Section 721 Exchange into an UPREIT?

A **REIT (Real Estate Investment Trust)** is a company that owns, operates, or finances real estate, and its stock is publicly traded. An **UPREIT (Umbrella Partnership Real Estate Investment Trust)** is a real estate investment partnership where the REIT serves as the general partner, and real estate investors are the limited partners. A Section 721 Exchange allows real estate investors to transfer their property into an UPREIT tax-free (or tax-deferred). IRC §721 governs the tax-free contribution of real estate to an operating partnership in exchange for an ownership interest in the partnership.

UPREITs utilize IRC §721 to acquire property from investors looking to exchange their real estate for an investment managed by professionals. At a later time, the investor can exchange their UPREIT partnership units for publicly traded shares of the REIT, which can then be sold on the securities market. This exchange of UPREIT units for REIT stock shares is a taxable event. However, this occurs simultaneously with the sale of the REIT shares, allowing the investor to cash out their investment, either fully or partially, at capital gains rates. This structure offers professional management and liquidity to real estate investors.

For a real estate investment to be contributed to an UPREIT, it must meet the REIT's investment criteria, which typically require institutional-grade properties. If an investor's property does not meet this standard, they can first convert their real estate into institutional-grade property via a sale and exchange under IRC §1031, followed by a replacement investment in a syndicated tenancy-in-common (TIC) investment. This TIC investment can then be contributed to the UPREIT in exchange for operating partnership units. Some REITs can assist taxpayers with this type of transaction.

Section 16: What Realtors Should Know About 1031 Exchanges

Realtors are often the first to recognize the potential advantages of a Section 1031 Exchange for real estate sellers. When a seller plans to replace qualifying real estate with a replacement property, recommending a Section 1031 Exchange should be considered. A seller can engage the services of an Exchange Intermediary at any point after the contract is signed, up until the closing day. However, it is too late to do so after the closing has taken place.

Accommodation Language in the Contract
It is common to include accommodation language in the contract to buy and sell real estate, informing the other party about the 1031 exchange and requesting their cooperation. The accommodation language might read as follows:

For a Seller:
"A material part of the consideration to the seller for selling is that the seller has the option to qualify this transaction as a tax-deferred exchange under Section 1031 of the Internal Revenue Code. The purchaser agrees to cooperate in the exchange provided the purchaser incurs no additional liability, cost, or expense."

For a Buyer:
"This offer is conditional upon the seller's cooperation, at no cost, to allow the purchaser to participate in an exchange under Section 1031 of the Internal Revenue Code at no additional cost or expense. The seller hereby grants the buyer permission to assign this contract to an Intermediary, notwithstanding any other language to the contrary in this contract."

While accommodation language is not mandatory, it may be omitted if it would disadvantage the taxpayer by revealing their plan to sell and replace property under IRC §1031, especially given the pressures created by the exchange "time clocks."

Assignment of Contracts
If a Realtor is aware that a buyer intends to assign the contract to an Intermediary as part of an exchange, it is helpful to note the buyer as "John Doe or Assigns" in the contract.

In California, the CAR AOAA form is recommended for such an assignment.

Settlement Statements
IRC §1031 does not provide specific guidelines for the preparation of settlement statements for property exchanges, nor does the Colorado Real Estate Commission have any special requirements for exchanges involving an Intermediary.

Intermediaries often instruct closing agents to list the Intermediary as the seller on behalf of their client. While this is not a requirement under IRC §1031, it can add extra burden at closing since the Intermediary must sign the settlement statements.

An occasional practice, though unnecessary, is for the title company to prepare a second set of settlement statements in which the Intermediary appears as both the buyer and the seller. These statements mirror each

other, balancing debits and credits. The intention is to reflect a "chain of title," but this practice is not mandated by IRC §1031.

Our recommendation is to prepare a single set of settlement statements in the usual manner, ensuring that the total proceeds due to or from the Exchanger is zero. The statements should reflect a debit or credit for "Exchange Funds - STAN 1031" as a transaction item "above the bottom line," representing the amount of funds transferred to or from the Intermediary at closing.

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ADDITIONAL TOPICS

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The Capital Gains Tax Rules
(In A Nutshell)

The American Taxpayer Relief Act of 2012 established the tax treatment for long-term capital gains. The top rate for capital gains and dividends is 15% for single taxpayers with incomes of $400,000 or less ($450,000 for married taxpayers). For incomes exceeding this threshold, the top rate for capital gains and dividends is 20%.

Here is a summary of the federal long-term capital gains tax rules for the sale of investment real estate, effective starting in 2013:

Maximum Long-Term Capital Gains Tax Rates (for property held 12 months or longer):

- **20%**: High-income taxpayers (as outlined above)
- **15%**: Taxpayers in tax brackets higher than 15%
- **0%**: Taxpayers in the 10% or 15% regular tax brackets

25% Rate for Depreciation Recapture:
Depreciation deductions taken on real estate that is sold are taxed at a maximum rate of 25% (15% for taxpayers in the 10% and 15% tax brackets). The remaining gain from the sale of depreciable real property is taxed at the rates mentioned above.

The 3.8% Medicare Tax:
Effective in 2013, a 3.8% Medicare tax was imposed on capital gains from real estate sales for high-income taxpayers. High-income taxpayers are defined as those with gross income over $200,000 for individuals ($250,000 for married taxpayers). This tax applies only to the portion of the gain that causes adjusted gross income to exceed these thresholds.

Exceptions for Real Estate Sales:

- Real estate used in a trade or business is not subject to this tax.
- Real estate sold by Real Estate Professionals is also exempt. A Real Estate Professional is someone who spends more than half of their working time (and at least 750 hours per year) in real property trades or businesses in which they materially participate.

For a married couple filing jointly in 2016, using the standard deduction, they are in the 10%/15% tax bracket until their adjusted gross income (including capital gains) exceeds $96,000.

State Taxes:
State taxes vary by state and should also be taken into account when estimating the total tax from the sale of real estate.

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Capital Gain Worksheet

Sale of Depreciable Real Estate

Calculation of Adjusted Basis –

Purchase price		$	(1)
Improvements added after purchase			(2)
Deferred gain from previous 1031 exchange, if any		( )	(3)
Less depreciation taken during ownership		( )	(4)
Adjusted Basis	(lines 1 + 2 - 3 - 4)	$	(5)

Calculation of Capital Gain -

Sale price		$	(6)
Less adjusted basis	(line 5 above)	( )	(7)
Capital Gain	(lines 6 minus 7)	$	(8)

Type of Capital Gain -

Depreciation Recapture	(line 4 above)	$	(9)
15%/20% rate gain	(lines 8 minus 9)		(10)
Total Capital Gain	(lines 9 + 10)	$	(11)

Tax rates vary on capital gains depending on the taxpayer's total income. Taxpayers should consult with their tax professional to determine what the tax will be on their capital gains.

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Seller Carrybacks and Dispositions

A Seller Financed Sale is generally not compatible with a Section 1031 Exchange of real estate. This is because a promissory note received by the seller is considered property that is not "like-kind." However, if seller financing is required due to specific circumstances and a delayed exchange with an Intermediary is used, it is possible to maintain Section 1031 Exchange treatment by following one of these procedures:

- **Cash Exchange for the Promissory Note**: The taxpayer can bring cash to the closing table to exchange for the promissory note. This would offset any boot received. This can occur either at the closing for the Relinquished Property or the Replacement Property. However, it is important not to use acquisition financing to fund the cash at the Replacement Property closing, as the IRS would view this as additional debt boot paid to offset cash boot received, which does not work. If cash is brought to the Replacement Property closing, the Intermediary must hold the note until the closing takes place.
- **Holding the Promissory Note**: The Intermediary can take and hold the promissory note as part of the exchange proceeds and keep it until the disposition occurs. This includes holding the note until cash can be brought to the Replacement Property closing as described above. Alternatively, the note could be paid off while being held by the Intermediary prior to the Replacement Property closing, or the taxpayer or an investor could buy the note from the Intermediary while it is in the Intermediary's possession (see below).
- **Selling the Promissory Note**: The Intermediary can sell the promissory note to a financial institution or investor and use the cash received to acquire qualifying replacement real estate for the taxpayer under the Exchange Agreement.
- **Using the Promissory Note for the Replacement Property Purchase**: The Intermediary could use the promissory note to help pay for the purchase of the Replacement Property. However, a complication arises because the note, when in the hands of the seller of the Replacement Property, is considered a third-party note. This makes it ineligible for installment sale reporting under IRC §453. As a result, the seller of the Replacement Property may be disincentivized from accepting the note as part of the consideration for the sale of their property. This issue becomes more problematic if the seller is also attempting to do their own 1031 Exchange.

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The Tax Rules for Sale of a Personal Residence
(In A Nutshell)

Effective for sales occurring after May 6, 1997, the following rules apply:

- **$250,000 tax-free gain ($500,000 for married couples filing jointly).**
- **First Two-Year Rule**: The taxpayer must have lived in the residence for at least two of the previous five years.
- **Second Two-Year Rule**: A second home sale within a two-year period is not eligible for this exclusion. The exclusion can only be used once in any two-year period.
- **Exception**: Any depreciation taken on the property after May 6, 1997 (such as for rental, home office, etc.) remains taxable at a maximum 25% tax rate.
- **Exception**: If the residence was acquired as replacement property in a 1031 Exchange, it must be owned for five years and lived in for at least two of those five years to qualify (per the American Jobs Creation Act of 2004).
- **Exception**: Non-Qualified Use after January 1, 2009 — Any period during which the residence was not used as a primary residence does not qualify for the exclusion. The gain on the sale must be prorated between qualifying and non-qualifying gain. The non-qualifying portion is determined by the number of months the residence was not the taxpayer's primary residence after January 1, 2009, divided by the total months of ownership since purchase (per the Housing Act of 2008). Further details on this rule are provided below.

A prorated exclusion is available for taxpayers who sell within two years or fail to meet the two-year rule due to circumstances like employment changes, health issues, or other reasons specified by Treasury Regulations. For example, if a taxpayer sells after one year of residence or experiences a second sale after one year, they may qualify for 50% of the exclusion if the sale is due to qualifying circumstances.

Taxpayers with gains that exceed these exclusion limits do not receive any relief and must pay taxes on the excess gain.

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2008 Housing Bill Modifies Rules For Sale of a Personal Residence

The Housing Assistance Tax Act of 2008 introduced changes to the Section 121 exclusion of gain from the sale of a primary residence.

Under Section 121 of the Internal Revenue Code, a taxpayer can exclude up to $250,000 ($500,000 for married couples filing jointly) of the gain from selling a primary residence, provided they have owned and lived in the property for at least two years during the five years leading up to the sale. However, any depreciation claimed on the property since May 1997 is not excluded from taxable gain.

To qualify for the Section 121 exclusion, the property must have been the taxpayer's primary residence for at least two years within the five-year period prior to the sale. Taxpayers often own multiple residences, but only the primary residence qualifies for the exclusion. A second residence, or a property that was not the primary residence for the required two years, does not qualify for the exclusion. The 2008 Housing Act addresses cases where the taxpayer is selling a residence that was not always their primary residence, such as:

- The taxpayer moves into a second residence, lives in it for two years, and then sells it.
- The taxpayer moves into a residence previously used as a rental property, lives in it for two years, and then sells it.
- The taxpayer sells a residence they lived in for two years within the past five years, but which is no longer their primary residence (e.g., converted to a second home or rental property).

Effective January 1, 2009, the Section 121 exclusion no longer applies to any gain attributable to periods of "nonqualified use" of the residence.

For example, if a taxpayer owned a home for four years as a second home or rental property, then moved into it, lived there for two years, and then sold it, the exclusion would need to be prorated:

- Two-thirds of the gain would not qualify for the $250,000 exclusion.
- One-third of the gain would qualify for the exclusion.

Nonqualified Use: Nonqualified use refers to any period during which the residence is not used as the taxpayer's primary residence. For taxpayers with multiple residences, the primary residence is the one in which they spend the most time.

Under the 2008 Tax Act, nonqualified use is considered only for periods after January 1, 2009. Any nonqualified use before this date is not considered when calculating the period of time subject to the Section 121 exclusion.

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Additionally, periods when a taxpayer has discontinued using a residence as their primary home are not considered in determining nonqualified use.

Impact on 1031 Exchanges: Taxpayers often exchange investment property for qualifying replacement property, which they plan to convert to a personal residence after one or two years. The goal is to eventually sell the property and qualify for the Section 121 exclusion on the gain from the sale (excluding depreciation taken since May 1997).

The new law affects this strategy. Any period of nonqualified use after January 1, 2009, will be subject to the new limitations on the Section 121 exclusion.

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How to Roll-Over Investment Property To a Personal Residence and Cash-Out Under IRC §121 "Tax-Free"

(IRC §1031 and §121)

Under IRC §121, taxpayers can exclude up to $250,000 ($500,000 for married couples filing jointly) of gain from the sale of their primary residence, provided they have owned and lived in the property for at least two out of the last five years.

For years, taxpayers have known they could take advantage of the Section 121 exclusion to sell rental properties "tax-free." This was possible by converting a rental property into a primary residence, living there for two years, and then selling it without paying tax, as long as the property met the requirements of IRC §121. Converting a rental property to a personal residence is not a taxable event.

But what if the rental property isn't ideal for living in for two years? The solution is a 1031 Exchange to acquire a more suitable property. Savvy real estate investors are also aware that they can use a 1031 Exchange to roll out of an investment property, acquire a qualifying residential property, rent it for at least one year (recommended by exchange professionals), and then convert it into a personal residence. After living in the property for two or more years and owning it for five years, they can then take advantage of the Section 121 exclusion on the gain from the subsequent sale.

This five-year ownership requirement was established by the American Jobs Creation Act of 2004, which imposed a new rule that property acquired through a 1031 Exchange must be owned for five years before qualifying for the Section 121 exclusion. The two-year residency requirement, however, remains the same.

Exceptions

1. **Depreciation After May 6, 1997**: Any depreciation claimed on the property after May 6, 1997 is not eligible for the Section 121 exclusion and must be reported as income, even if the home otherwise qualifies for the exclusion. This applies to rental properties converted into a personal residence, as well as any portion of a personal residence that has been depreciated (e.g., home office).

   However, depreciation taken on the property before May 6, 1997 does not count and is not taxed under §121. This is beneficial for rental properties that were heavily depreciated before 1997 and later converted into a personal residence.

   It is also important to note that the depreciation recapture rule applies to depreciation taken on the residence being sold, not on any previous rental properties exchanged under IRC §1031. Depreciation taken on a prior rental property does not carry over to the replacement property for the purposes of this recapture rule.

2. **Non-Qualified Use**: The Housing Assistance Tax Act of 2008 introduced restrictions on the Section 121 exclusion for properties with periods of non-qualified use. Specifically, any time after January 1, 2009,

when the residence was used for rental purposes (or for non-qualified use) is considered "non-qualified use," and the Section 121 exclusion must be prorated. This means only part of the gain from the sale may qualify for the exclusion.

This change impacts rental properties converted into personal residences after May 1, 2009, and complicates the strategy of rolling an investment property into a personal residence for the purpose of later qualifying for the Section 121 exclusion. For more details on this rule, refer to the 2008 tax act here.

Conclusion

Taxpayers who convert investment property into their personal residence via a 1031 Exchange can still benefit from the Section 121 exclusion on the sale of that residence, subject to the exceptions mentioned above. While this strategy has become more complex, it remains a popular option for many taxpayers looking to optimize their tax planning.

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Vacation Homes and 1031 Exchanges

Can a vacation home qualify for a 1031 Tax-Deferred Exchange? Most tax and exchange professionals believe it can, provided the vacation home is used, at least in part, for rental purposes. For example, if a vacation home is used 50% for personal use and 50% for rental or investment purposes, then the 50% portion of the property qualifies as investment property under IRC §1031. However, the personal use portion would not be eligible for 1031 Exchange treatment. If the vacation home is used entirely for personal purposes, it does not qualify under IRC §1031.

What if the vacation home is partly used for personal purposes and partly for investment but is never rented out? In this case, the answer is "it depends." It depends on the extent of personal use by the taxpayer. Property held primarily for personal use does not qualify as investment property under IRC §1031(a). However, incidental personal use of property that is otherwise considered investment property does not disqualify it from 1031 Exchange treatment (PLR 8103117). The IRS does not define "incidental personal use," but it generally refers to limited personal use that does not interfere with the property's investment purpose. More significant personal use could disqualify the property if it is never rented out by the taxpayer.

Under what conditions can 100% of a vacation home qualify for a 1031 Exchange? According to IRC §280A(d), a taxpayer's dwelling can qualify as a rental property (and not a "residence") for tax purposes if their personal use of the property is less than the greater of:

1. 15 days, or
2. 10% of the total days the property is rented at fair market value rents during the year.

Personal use includes use by the taxpayer's family members but excludes time spent working at the residence. While IRC §280A aims to limit deductions related to the rental use of a residence, most tax professionals do not believe it directly applies to 1031 Exchanges. However, meeting the minimal personal use requirements of IRC §280A is often viewed as a solid approach to qualifying a vacation home for 1031 Exchange treatment. Additionally, the IRS issued a "safe-harbor" rule in March 2008 with similar language to IRC §280A, providing further guidance on qualifying properties for 1031 Exchanges.

If a taxpayer cannot meet these rules due to excessive personal use, they could consider converting the property into a qualifying investment by discontinuing all personal use for at least one year. During this time, the property should be treated as an investment, and expenses related to the property should be reported as "investment-related expenses." Renting the property would help support this approach, but it is not required.

The IRS issued Rev. Proc. 2008-16 in March 2008 to provide taxpayers with guidance on qualifying vacation homes as investment properties. This revenue procedure applies not only to vacation homes but also to any second residence owned by the taxpayer and is effective for exchanges occurring after March 9, 2008.

Failure to meet the safe-harbor requirements does not automatically disqualify the exchange from §1031 treatment but does make it more likely that the IRS could challenge the exchange.

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IRS Issues Safe Harbor for 1031 Exchange of Residences
(Including Vacation Homes)

Rev. Proc. 2008-16 provides a "safe harbor" for determining whether dwelling units involved in an exchange qualify for §1031 treatment. This safe harbor ensures that the IRS will not challenge whether a dwelling unit is considered property held for use in a trade or business or for investment purposes under §1031. However, failing to meet the safe harbor requirements does not automatically disqualify the exchange from §1031 treatment.

A dwelling unit is defined as real property that includes a house, apartment, condominium, or similar structure that provides basic living accommodations, such as sleeping space, a bathroom, and cooking facilities. Essentially, it is considered a residence.

Safe Harbor Requirements
The IRS will not challenge whether a dwelling unit qualifies as property held for business or investment use for §1031 purposes if the following conditions are met:

1. The relinquished property must be owned by the taxpayer during the 24-month period ending the day before the exchange.
2. The replacement property must be owned by the taxpayer during the 24-month period beginning the day after the exchange.
3. During the 24-month periods before and after the exchange, the following must be true:
    - The residence must be rented to another party at a fair rental for at least 14 days.
    - The period of personal use by the taxpayer or others cannot exceed the greater of 14 days or 10% of the days the residence is rented at fair market value.

Personal Use
Rev. Proc. 2008-16 defines personal use as any day the taxpayer or someone related to them uses the dwelling unit for personal purposes, as outlined in IRC §280A(d)(2) (considering §280A(d)(3) but not §280A(d)(4)). This includes situations where the residence is used by:

1. The taxpayer, anyone with an interest in the property, or any family member of these individuals.
2. Any individual using the property under a reciprocal use arrangement.
3. Any individual, other than an employee whose use is excluded under §119 (use for the employer's convenience), unless the property is rented for fair market value for that day.

If the safe harbor requirements of Rev. Proc. 2008-16 are not met, the exchange is not automatically disqualified from §1031 treatment, but the IRS may challenge the exchange.

Effective Date
Rev. Proc. 2008-16 applies to exchanges of dwelling units occurring after March 9, 2008. It does not affect the tax treatment of exchanges occurring before this date.

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How to Report an Exchange of Property Used Partly as a Personal Residence and Partly for Business or Investment Purposes

Revenue Procedure 2005-14 provides guidance on tax reporting for exchanges involving properties that serve as both residential and business/investment properties under IRC §§121 and 1031.

Background

A homeowner can exclude gain from the sale of a personal residence under IRC §121 if the property has been owned and used as a primary residence for at least two of the five years preceding the sale. The maximum exclusion is $250,000 for individuals ($500,000 for married couples filing jointly). However, this exclusion is reduced for any rental or non-qualified use of the property after January 1, 2009, based on the total years of ownership. Additionally, any depreciation taken on the property since May 6, 1997 is not eligible for exclusion under §121.

Treasury Regulation 1.121-1, issued in 2002, clarified that the IRC §121 exclusion applies to entire structures used partly as a personal residence and partly for business or investment purposes. The business/investment portion of such properties can also qualify for tax deferral under IRC §1031. Therefore, a property can be eligible for both the §121 exclusion and §1031 deferral under the Internal Revenue Code simultaneously.

Revenue Procedure 2005-14 provides six examples illustrating how to report exchanges of properties eligible for both IRC §§121 and 1031 exclusions in various circumstances. For these examples, assume the taxpayer is single and qualifies for a $250,000 gain exclusion under IRC §121. In practice, the exclusion will likely be reduced due to non-qualified use after January 1, 2009.

Rental Property Converted from Personal Residence

IRC §121 does not require the taxpayer to be residing in the property at the time of sale to qualify for the exclusion. As long as the taxpayer has owned and lived in the property for at least two of the last five years, it qualifies for the gain exclusion, even if it's being used as a rental at the time of sale. The taxpayer can exclude up to $250,000 in gain under IRC §121, minus any depreciation taken since May 6, 1997. Any gain attributable to depreciation or exceeding the §121 exclusion is eligible for deferral under IRC §1031. The gain is first excluded under §121 and then deferred under §1031. Cash boot up to $250,000 received from the exchange will be tax-free under §121, even if part of the property was used for business/investment purposes. The basis in the replacement property will be adjusted for any gain excluded under §121.

Combination Property - One Property, Two Structures

If a taxpayer owns a property with both a personal residence and a business structure, it’s considered a combination property. Part of the property is eligible for gain exclusion under IRC §121, while the other part may qualify for tax deferral under §1031. The exchange must be treated as if two properties were being sold and exchanged separately. The value of the replacement property must be allocated between personal and business uses, and the gain must be measured separately for each part of the property. If the business

portion of the relinquished property is exchanged for a business-use replacement property, there may be taxable boot if the exchange results in a trade-down.

The business portion of the relinquished property cannot be excluded under IRC §121, and the personal residence portion cannot be deferred under §1031. The basis in the replacement property must be calculated separately for the personal and business portions.

Dual Use Property - One Structure Used for Both Residential and Business Purposes

If the taxpayer exchanges a property that is used both personally and for business, any gain realized on cash or debt reduction boot will be tax-free up to $250,000 under IRC §121, even if the gain results from a trade-down of the business portion of the relinquished property (excluding any depreciation taken since May 6, 1997). However, any depreciation taken on the property since May 6, 1997 is eligible for tax deferral under IRC §1031.

The key variations include:

- All gain on the relinquished property, up to $250,000, can be excluded under IRC §121, excluding depreciation taken since May 6, 1997. Depreciation allocable to the §1031 portion of the property can be deferred under IRC §1031, while depreciation related to the personal residence portion cannot be deferred.
- Cash (or debt reduction) boot received on the exchange is tax-free under IRC §121 up to $250,000, even if it relates to the §1031 portion of the property, excluding post-May 6, 1997 depreciation.

- Any gain from the exchange attributable to the personal residence portion of the property that exceeds $250,000 is taxable under IRC §121 and cannot be sheltered under IRC §1031.

Revenue Procedure 2005-14 does not address closing procedures for exchanges involving properties used partly for residential and partly for business/investment purposes. Prior guidance from Treasury Department Publication 523 (1998, now replaced by a new version) instructed taxpayers with dual-use properties to treat the sale as two separate transactions. Intermediaries often handled such exchanges by creating separate settlement statements, allowing the taxpayer to cash out the personal residence portion and use a 1031 Exchange for the business/investment portion. However, following Rev. Proc. 2005-14, this dual approach is no longer necessary for Dual-Use Properties. Nonetheless, separate settlement statements are still recommended for Combination Properties, as the data must be prorated accordingly.

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How to Build on Land You Already Own With Leasehold Interests

(Or How to Build on Land Owned by a Related Party)

The goal here is to structure the transaction as a safe-harbor reverse exchange under the guidelines set forth by Rev. Proc. 2000-37. This requires that the taxpayer take title to the improved property within 180 days of the Exchange Accommodation Titleholder (EAT) taking title to the taxpayer's Replacement Property. However, Rev. Proc. 2004-51 states that this won't work if the taxpayer has already held title to the property within the past 180 days, so careful planning is needed to comply with this rule.

The Procedure:

1. The taxpayer transfers their unimproved real estate to a related entity (e.g., a corporation, partnership, or LLC with multiple owners—a "Related Party").
2. After one or two months, the taxpayer sells the Relinquished Property under an Exchange Agreement. The 180-day Delayed Exchange clock starts.
3. The taxpayer enters into a "safe-harbor" Title holding Agreement with an EAT.
4. The Related Party leases the property to the EAT for 30 years at Fair Market Rent. The 180-day Reverse Exchange clock begins.
5. The EAT then constructs improvements on the ground lease.
6. The EAT transfers the ground lease, along with the improvements, to the taxpayer as Replacement Property for the exchange within 180 days of the title-holding agreement to comply with the safe-harbor reverse exchange procedures. Alternatively, the EAT itself may be transferred.

   a. However, this cannot occur before 180 days have passed since the Related Party received the land in Step 1, in order to comply with Rev. Proc. 2004-51, which stipulates that the taxpayer cannot receive Replacement Property it previously owned within the past 180 days.

7. The taxpayer continues paying lease payments to the related entity for two years before dissolving the entity and merging the property and improvements, ensuring the related-party exchange meets the two-year holding rule.

PLR 200251008 and PLR 200329021 approved arrangements similar to this (although slightly more complex). Rev. Proc. 2004-51 indicated it would review leasehold improvement exchanges like these, but currently, no safe-harbor has been established for such exchanges.

Observation: The taxpayer does not take title to the fee interest owned by the related party (the LLC). The Leasehold Interest is a new property created by the EAT and conveyed to the taxpayer by the EAT. Therefore, it can be argued that this is not a "related party exchange" under the rules of IRC §1031(f)(4).

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The "Farm Bill" Makes Ditch Stock Qualified for a Section 1031 Exchange of Real Estate

Mutual irrigation ditch, reservoir, or irrigation company stock (referenced in IRC §501(c)(12)(A)) may qualify as like-kind property for a fee interest in real estate due to Section 15342 of H.R. 2419, the Food and Energy Security Act of 2007 (the "Farm Bill"), which was signed into law on May 22, 2008.

The Farm Bill modifies IRC §1031(a)(2)(B) to exempt mutual irrigation ditch, reservoir, or irrigation company stock from the definition of "stocks, bonds, or notes," which are otherwise ineligible for a 1031 exchange. As a result, mutual irrigation ditch, reservoir, or irrigation company stock may (or may not; see below) be eligible for a 1031 exchange involving real property.

The amendment to Section 1031 was co-sponsored by Senators Allard and Salazar of Colorado. Typically, mutual irrigation ditch, reservoir, or irrigation stock ("ditch stock") is considered a water right used for irrigating crops on farmland. Water rights, as a form of mineral easement, are generally viewed as an interest in real estate, making them like-kind to a fee interest in real property. In states such as Colorado, farmland sales or exchanges often include ditch stock. The goal of the Colorado senators was to qualify ditch stock as like-kind to a fee interest in real estate for farmland exchanges. However, the Farm Bill's language leaves this intent somewhat unclear.

To qualify, Section 15342 of the Farm Bill clarifies that ditch stock must be recognized as real property, or an interest in real property, in the state where the corporation is located. This recognition must come either from the state's highest court or relevant state statute. In Colorado, mutual irrigation ditch companies are governed by specific state laws, and the District Court of Colorado, along with other cases, has recognized ditch stock as an interest in real property. Ditch stock in other states may or may not qualify depending on the legal framework of each state.

The ambiguity in the Farm Bill's language has raised concerns among experts, as it's possible that ditch stock may only be exchanged for other ditch stock. However, it is evident that the supporters of this amendment intended to treat ditch stock as like-kind to other real property interests.

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Related Party Solution to a Failed Reverse Exchange

In a typical Safe-Harbor Reverse Exchange, the taxpayer engages an Exchange Accommodation Titleholder ("EAT"), often a subsidiary of the Qualified Intermediary (QI), to temporarily hold title to a property that will later be transferred to the taxpayer as Replacement Property in a §1031 exchange. This arrangement is often used when the taxpayer needs to close on the purchase of a Replacement Property before the sale of the Relinquished Property has been finalized. Under the "safe-harbor" provisions of Revenue Procedure 2000-37, the EAT can hold the property for up to 180 days, during which time the taxpayer must find a buyer for the Relinquished Property, close on the sale, and complete the exchange by taking title to the Replacement Property.

But what should a taxpayer do if a buyer for the Relinquished Property cannot be found within 180 days?
In the past, the typical approach was to end the reverse exchange by transferring title of the Replacement Property to the taxpayer, thereby assuming the reverse exchange had failed. Alternatively, the EAT's title-holding service could be extended beyond the 180-day period, which would result in the arrangement no longer being considered a "safe-harbor" reverse exchange, and it would be classified as a "non-safe-harbor reverse exchange." However, there is also a third potential option.

Can a taxpayer sell the Relinquished Property to a related party, who then holds it for resale, in order to complete the exchange by taking title to the Replacement Property?
This strategy would involve the taxpayer selling the Relinquished Property to a related party, closing the sale as part of the 1031 exchange, taking title to the Replacement Property, and completing the exchange. While sales to related parties have always been allowed, it was previously thought that the related party would be required to hold the property for at least two years before it could be resold to a third party.

Under the related party exchange rules, when property is exchanged between related parties, each party is required by the Regulations to hold the property it receives for two years. A sale or disposition by either party within this period would disqualify the exchange, and both parties would need to amend their returns and report the exchange as a taxable sale. It was previously believed that a sale to a related party, followed by the purchase of Replacement Property from an unrelated party, would be subject to this two-year holding period. However, three private letter rulings (PLRs 200706001, 200712013, and 200728008) issued by the IRS in 2007 clarified that the two-year holding period does not apply in this scenario.

As a result, the taxpayer can sell the Relinquished Property to the related party, take title to the Replacement Property from the EAT, and complete the exchange. The related party can then hold the property for resale to a third party without being subject to the 180-day deadline or the two-year holding period. The related party will have a tax basis equal to the purchase price, so when the property is resold, there should be little or no taxable gain. This allows the taxpayer to complete the exchange successfully, and all parties involved benefit.

Who qualifies as a related party?
Related parties include:

- Family members, including brothers, sisters, half-brothers, half-sisters, spouses, ancestors, and lineal descendants.
- An individual and a corporation, partnership, or LLC in which the individual, along with family

members, owns more than 50% of the ownership.
- Two corporations, partnerships, or LLCs where the same person or owners, along with family members, own more than 50% of the ownership.

When using a related party in this manner, it is preferable (though not always possible) to utilize an existing party or entity, rather than creating a shell entity for the transaction that dissolves after the sale of the Relinquished Property. The related party should assume the benefits and responsibilities of ownership of the Relinquished Property, rather than simply acting as the taxpayer's agent. The purchase price should be fair market value.

When the related party eventually resells the property, any gain or loss may be considered short-term if the property has been held for less than 12 months. Therefore, it is important to price the sale to the related party based on the expected resale value.

Potential Ordinary Income from Sale to a Related Party

Sale of Depreciable Property to a Related Party
Under IRC §1239(a), any gain from the sale of depreciable property to a related party is considered ordinary income rather than capital gain. In a 1031 Exchange, only boot received in the exchange would be subject to taxation as ordinary income.

Sale of Property to a Related Party Partnership or LLC
According to IRC §707(b)(2), if property is sold to a related party partnership or LLC that does not hold the property as a capital asset, any gain from the sale will be classified as ordinary income, not capital gain. In the context of a 1031 Exchange, this would apply only to boot received in the exchange.

Sale of Property to a Corporation by a Shareholder
Under case law, if a shareholder sells property to a related party corporation (where the shareholder owns 51% or more) and the corporation's subsequent resale would result in ordinary income for the corporation, then the gain from the shareholder's sale to the corporation will also be treated as ordinary income, not capital gain. In a 1031 Exchange, only the boot received by the taxpayer will be taxed as ordinary income.