A Like-Kind 1031 Exchange How to Guide for Attorneys

Lawyers often advise their clients on whether they would benefit from tax deferral strategies such as Internal Revenue Code (IRC) Section 1031 like-kind exchanges. This guide provides attorneys with a refresher on the 1031 exchange basics, questions to consider, and the steps to a successful 1031 exchange.

1031 Exchange Basics

Timing

Closing attorneys may determine while preparing closing documents that the property being sold represents an investment. If the property is an investment, it is in the mutual interest of the lawyer and Seller to ask two questions.

- Is the Seller familiar with a 1031 exchange?
- Is their intent to replace with another investment property?

If the answer to the second question is "yes" or "maybe", then, it is suggested the Seller contact a Qualified Intermediary (QI) to discuss the transaction characteristics and exchange steps. If the decision is to initiate an exchange, the QI can prepare exchange documents as late as with the Sellers sitting at the closing table. Once the proceeds due are in the Seller's possession, the opportunity to enter a 1031 exchange too late.

Internal Revenue Code 1.1031

The 1031 code applies to real property held for business use or investment. The exchange results in no gain being recognized when like-kind property is replaced. No gain applies to the deferral of federal and state capital gains and recaptured depreciation taxes. Depending upon the property, this deferral represents an interest free loan that can range up to 40 percent of the old properties' sales price. The deferred taxes represent additional working capital that does not need to be borrowed saving the interest cost and maximizing the full benefit of the tax deferral strategy.

Achieving optimal exchange benefits requires:

- No cash out or mortgage reduction
- Net sales price of each property sold/exchanged must be less than or equal to the replacement property asset.

State Regulations

Eight states have legislated QI regulations that if not followed subjects the QI to criminal or civil penalties. The requirements vary by state but share in common either a $1,000,000 fidelity bond or use of a qualified escrow account and a minimum $250,000 error and omissions policy. The eight states are Washington, Oregon, California, Idaho, Nevada, Colorado, Virginia and Maine.

Questions to Consider

Is the intent to replace with like-kind property? If selling a medical office building, will the company replace with another real property of equal or greater value?

- Is the titleholder of the old property the same as for the new property? If not, then a possible solution is the dropping of the title to another entity no less than a year prior to the sale given that entity will be the same titleholder for the new property. Consider IRS Form 1065, Schedule B, questions 13 and 14 as to whether you wish to proceed with the drop and swap.

- Is the entity acquiring the property related to the seller? If so, the related party rule requires the property is held for a minimum of two years otherwise, the deferred tax is triggered to the taxpayer. If buying property from a related party, the related party must also be initiating a 1031 exchange for their property, not cashing out.

- Is the Seller of real property a non-resident alien or foreign entity? If so, they must comply with the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) and secure a certificate from the IRS in Philadelphia, exempting them from a percentage (of the sale) withholding requirement.

- Is the "hold" time greater than one year? Though there is no hold time specified in the 1031 code, the shorter the time the more substantial the fact set needs to be. Preferably, the property should be held for at least one year and a day to secure the lower long-term capital gains rate. Revenue Procedure 2008-16 does specify a two-year hold time for dwelling units.

How a 1031 Exchange Works

Once the decision to initiate an exchange is made, a Qualified Intermediary (QI) is engaged. The QI cannot be a disqualified person or an agent of the taxpayer. This includes the taxpayer's employee, attorney or firm, accountant, investment banker, realtor or broker within the two-year period prior to the date the property is sold in a forward or purchased in a reverse exchange.

The QI should convey their expertise by the number and type of exchanges accommodated over several years. It is suggested the QI be a member of the Federation of Exchange Accommodators (FEA) and a Certified Exchange Specialist® (CES).

As a member of the FEA, the QI principal responsible for managing the exchange funds undergoes a yearly criminal background check. In addition, the CES yearly conveys their promise to uphold the FEA Code of Ethics, the violation of which can result in expulsion.

QI Compensation

A QI is compensated by a fee based on the complexity and number of relinquished/replacement properties and interest earned on the exchange funds. Proceeds over $2,000,000, require the QI to "*use a 91-day rate which is the investment rate on a 13-week (generally, 91-day) Treasury bill determined on the issue of date that is the same as the date the exchange facilitator loan is made or, if the two dates are not the same, the issue date that most closely precedes the date that the exchange facilitator loan is made. This rate is based on semi-annual compounding and may be found at https://www.bankrate.com/rates/interest-rates/91-day-treasury-bill.aspx Also, in recognition that the short-term applicable Federal Rate (AFR) may be lower than the 91-day rate, the final regulations provide that the taxpayers must apply the lower of the 91-day rate or the short-term AFR when testing or imputing payments on an exchange facilitator loan under section 7872*" per Internal Revenue Bulletin 2008-34.

The QI will discuss the transaction with the taxpayer or designated contact such as the Chief Financial Officer. A qualified escrow account (QEA) is utilized for all exchanges. The QEA provides the best protection for the exchange funds requiring two signatures to authorize funds disbursement, one from the taxpayer and the second from the QI.

Assignment Language

Assignment language is used in both the sale and purchase contracts. The assignment language assigns the rights of the contract to the QI but not the obligations. It is not necessary to have the assignment language when the taxpayer is selling but required when acquiring property given the Seller's permission is required acknowledging the assignment.

Exchange Closing Steps

Prior to the closing or before, exchange documents are provided by the QI for the taxpayer to review and sign. The documents are created in accordance with the IRC 1031 requirements. The settlement statement reflects the Seller/Buyer is the QI for the benefit of the taxpayer. Debt, selling and closing expenses are paid with the net proceeds wired to the taxpayer's escrow account created under the taxpayer's name and identification number.

Identification Steps

Identification of potential replacement properties is required in writing to the QI no later than the 45th calendar day at 11:59 P.M. Either up to three properties can be identified regardless of value or if four are identified, the aggregate value cannot exceed 200 percent of the relinquished property sales price. If four or more are identified and they exceed 200 percent of the relinquished property's sales price, 95 percent of what is identified must be acquired. In a forward exchange, the taxpayer can close on the replacement property as soon as the same day after the closing of the relinquished property.

The second leg of the exchange is scheduled to close on the replacement property. The QI again works with the title or closing attorney to reflect the 1031 exchange in the settlement statement. Exchange proceeds are wired to the escrow or closing title office on the day of or prior to the closing. In both closings the contract is assigned to the QI and properties direct deeded to the Buyer in the sale and to the taxpayer, as Buyer in the second leg.

Exchange Strategies

Either a forward or reverse exchange strategy is structured pending the transaction requirements. In a forward exchange, the old or relinquished or property is closed in the first leg, followed by the closing on the replacement property. In a reverse, the replacement property is closed prior to the closing on the relinquished property. From the day following the closing starts the identification period or 45 calendar days, followed by an additional 135 calendar days to complete the exchange.

A reverse exchange uses an Exchange Accommodator Titleholder (EAT) to take title to (or "park") either the old or new property for the duration of the exchange. The EAT is a single member limited liability company (SMLLC) with the QI principal as the manager. To avoid state transfer taxes, the SMLLC can be conveyed to the taxpayer when the replacement property is parked. The EAT can take title to the old property and sells to the Buyer allowing the taxpayer to take title to the new property. Construction and improvement exchanges follow a similar format with the EAT on title to the replacement property and pays vendor invoices from the exchange proceeds. Taxpayers can build on land already owned in a leasehold improvement exchange. This requires the property to be improved is titled to a related party six months prior to the relinquished property closing.

Benefits

In addition to the tax deferral, the 1031 exchange provides tax payers the ability to acquire replacement property for the following reasons:

- ➔ Relocation
- ➔ Appreciation
- ➔ Depreciation
- ➔ Cash Flow
- ➔ Diversification
- ➔ Consolidation

Next Steps

Leading up to the decision to initiate an exchange, there are many questions to consider. Seeking counsel with a QI will provide answers to many questions. The QI can respond to questions relating to the steps of the exchange. Questions relating to estate laws, tax rates and partnership issues are outside their scope.

Alternative Solution: Deferred Sales Trust

If the taxpayer does not want to own replacement property, a Deferred Sales Trust (DST) is an alternative to the 1031 exchange. Many QIs will have the language imbedded in their exchange agreements allowing the taxpayer to convert a 1031 exchange to a DST. The DST follows the typical sale, but at the closing the property is sold to a trust who in turn sells it to the Buyer. The proceeds are invested by the trust in marketable securities and annuities determined and approved by the taxpayer. The DST is similar to a Section 453 installment loan. Illustrations are available given the taxpayer answers a series of questions to determine whether the DST makes sense.

About the Author

Andy Gustafson, Certified Exchange Specialist®, serves as the managing member of Atlas 1031 Exchange, LLC, a worldwide accommodator of Internal Revenue Code Section 1031. To date, he has accommodated over 1,400 real and personal, simple and complex, domestic and international 1031 exchanges. You can reach him at 800.227.1031 and info@atlas1031.com.