1031 Exchanges: Benefits for Franchisees and Business Owners

Smart franchisees and business owners are always looking for ways to increase cash flow and reduce expenses. Strategies to consider for improving the bottom line are moving to a better location, converting a business to a proven franchise, and upgrading to more efficient equipment. If selling a franchise or business, learning about ways to minimize taxes is crucial, for securing adequate capital for future acquisitions.

Creative Financing Tool

A creative financing tool known as a 1031 exchange defers capital gains and recaptured depreciation taxes when selling and replacing real property of equal or greater value. Savings from a tax deferral represent an indefinite interest free loan for higher yielding acquisitions or for asset portfolio adjustments. Knowing what property can be exchanged, in what time frame, and what should be avoided will help you and your advisors take advantage of the tax deferral and self financing strategy.

1031 Tax Expenditures

In 2011, the tax expenditure for 1031 exchanges in the United States was estimated as $2.5 billion. Individuals and corporations deferred $.8 billion and $1.7 billion in taxes respectively. These numbers are predicted to grow as more and more owners learn about their options to defer taxes and save money for new acquisitions.

Deferral Of Gain On Like-Kind Exchanges			
Estimated Revenue Loss			
[In billions of dollars]			
Fiscal Year	Individuals	Corporations	Total
2010	0.7	1.4	2.1
2011	0.8	1.7	2.5
2012	1.2	2.0	3.2
2013	1.4	2.3	3.7
2014	1.5	2.6	4.1

The accepted rationale for a 1031 exchange is that it represents a continuation of the investment from the old to the new property. The tax obligation does not go away but it is postponed providing an incentive to acquire new equipment, land, commercial and single family rental properties. Furthermore, the Internal Revenue Service (IRS) 1031 code allows the taxpayer, independent of income tax bracket, to easily and inexpensively replace one asset for another without the immediate tax consequences. 1031 exchanges do not discriminate on the basis of age or ethnicity.

IRS Code Section 1.1031

The IRS Code Section 1.1031 states "no gain will be recognized on property held for productive use in business or investment when exchanged for like kind property held for productive use in business or investment." Keywords are *property* and *held*. "Property" refers to real property while "held" means the time when the property is used in productive use of a business or investment. However, there is no time frame stated in the 1031 code. The shorter the time held, the greater the facts need to be to substantiate that the property is used for the proper intent rather than for a flip or for profit.

Example 1: Construction 1031 Exchange

A franchisee has elected to sell one of their franchises operated for ten years to relocate to a higher traffic location. The sales price of the franchise is $1,600,000. The sales price is composed of real property for $1,360,000 and $240,000 for personal property. Selling expenses are a sales commission of 4% or $64,000, title and attorney fees of $16,000 for a net selling price of $1,520,000. The current mortgage is $600,000 and is paid off at the first leg closing. The tax triggered is $176,172 representing $38,462 in recaptured depreciation, $108,000 in federal capital gains and $29,711 in state tax.

Rather than paying the tax, the franchisee can use the $176,172 interest free loan towards acquiring the land and constructing the new franchisee location in a construction 1031 exchange. The new location valued at $1,800,000 will generate a monthly cash flow and appreciate at a conservative estimate of 3% per year. In ten years, the return on investment of $1,800,000 is an estimated $619,049 or 34.4%. The use of the $176,172 taxable dollars will conservatively return 22.5% or $39,646.

Example 2: Selling Equipment

A business owner of a restaurant upgrades his 11-year old furniture and refrigeration equipment. The personal property sells for $27,000. The sale triggers a recognized gain or tax due of $8,468 representing a recaptured depreciation of $8,750, federal capital gain loss of $1,200 and state (state capital gains tax of 3.4%) capital gain of $918.

Example 3: Selling a Business

A retiring dentist sells his 25-year old multi site practice for $3,400,000. The sales price reflects two commercial buildings located in high visibility prime locations. The real estate represents 84 percent of the sale, or $2,841,600. The taxpayer wants his replacement property to be secure, low risk and generate a passive cash flow. With input from his accountant, two properties are selected including an oil and gas royalty in the Marcellus Shale field of Pennsylvania and a triple net single tenant lease with CVS Pharmacy as the tenant. A tax was paid on the remaining $358,400 representing equipment and a customer list.

The 1031 exchange allows the owner to indefinitely defer $557,898. The replacement properties generate cash flow and at death are conveyed to the taxpayer's heirs. If the heirs elect to sell soon after receipt, there is no tax, given they received a stepped up basis on the property.

1031 Eligible Property

Real property is exchanged for real property. A 1031 exchange has many rules and requirements, one of which is the use of a Qualified Intermediary to accommodate the exchange.

A partial list of eligible real property includes:

Land	Commercial property	Single family rentals
Oil an d gas royalties	Mobile home parks	Apartments
Thirty year leases	Timberland	Water rights

Property ineligible for 1031 consideration includes:

- Primary residence
- Inventory
- Partnership interests
- Indebtedness
- Stocks, securities and notes

1031 Exchange Strategies

Construction 1031 Exchange

In a construction exchange, the new property is titled or parked with an Exchange Accommodator Titleholder (EAT). The EAT uses funds from the sale of the old location along with a construction loan to pay the permits and contractor invoices. Prior to the 180th calendar day post the first leg closing or no later than the 185th calendar day, the title is conveyed to the franchisee inclusive of the improvements to the land. If the contractors have not finished, the title is still conveyed, but a determination of the percentage complete is made and applied to the deferred gain. If the value completed to date is equal to or greater than $1,520,000, then the entire $176,172 has been successfully deferred. If the percentage complete is less than the net selling price of $1,520,000, then the difference is taxable.

Leasehold Improvement 1031 Exchange

Leasehold improvement exchanges allow a taxpayer to improve property already owned. A thirty year lease or more is considered real property eligible as a 1031 replacement property. The lease and improvements made by a third party can be conveyed to the taxpayer given the lease is maintained for at least two years and the related party collects fair market ground rent from the taxpayer.

Proper planning is critical. The land to be improved must be owned by a related party six months prior to the start of the improvements.

Forward 1031 Exchange

In a forward 1031 exchange, the replacement property is purchased after the sale of the old property. The suggested steps to a forward 1031 exchange include:

- Determining capital gains and recaptured depreciation taxes triggered when the old property is sold.
- Working with a Realtor to list your property.
- Engaging a Qualified Intermediary (QI) to accommodate your exchange.
- Once in contract, scheduling a closing.
- At the closing 1031 exchange documents are prepared supporting your intent to affect a 1031 exchange.
- Net equity from the sale represents your exchange proceeds that are wired to an escrow account under your social security number.
- By the 45th calendar day, potential replacement properties are identified to the QI.
- A purchase contract is negotiated on the replacement property.
- Closing date is scheduled.
- At the second leg closing, exchange documents are prepared for signing.

- Exchange proceeds are wired to escrow or closing company.
- Exchange is completed by the 180th calendar day.
- A file is provided of signed exchange documents for you and your accountant.

Reverse 1031 Exchange

A reverse 1031 exchange is when the replacement property is purchased before the sale of the old property. It is a bit more complex given as in the construction exchange, either the new or the old must be parked temporarily with the Exchange Accommodator Titleholder (EAT). The decision of which property to park depends on whether a new loan is required on the replacement property or does the state where the property is located assesses a conveyance or transfer fee. The goal is to minimize the purchase process and taxes. Often times, it makes sense to park the old property to allow the franchisee or business owner to purchase the new property as normal. The typical steps to a reverse 1031 exchange include:

- Determine the capital gains and recaptured depreciation when the old property is sold.
- List the old property with a Realtor and work with them to identify the replacement.
- Engage a qualified intermediary (QI) to accommodate the reverse 1031 exchange and determine which property should be parked with the EAT.
- Once in contract for the replacement property schedule a closing.
- Secure financing requirements.
- When improvements are to be made to the replacement property, the EAT will be the titleholder. If not, the EAT will be conveyed title to the old property prior to the closing on the new property.
- By the 45th calendar day, the old or relinquished property is identified to the QI.
- A sales contract is negotiated on the old property and closing scheduled. If EAT is the titleholder, the EAT signs the sales contract with the taxpayer signing under "Read and Approved."
- At the closing the net equity received is wired to the taxpayer.
- Exchange is completed by the 180th calendar day post closing on the replacement property.
- A file is provided of primary signed exchange documents for you and your accountant.

1031 Requirements and Rules

The primary 1031 exchange rules include:

- The sale price of the replacement property is equal to or greater than the old or relinquished property. Otherwise, a tax is triggered on the difference.
- The taxpayer who sells is the taxpayer who buys.
- Replacement properties are identified by the 45th calendar day post closing with an additional 135 calendar days to complete the exchange.
- If the old property is sold to a related party, the property must be held for two years before selling or the tax deferred by the 1031 exchange is due.
- You can purchase the replacement property from a related party, only if they are also initiating a 1031 exchange.
- The qualified intermediary cannot be considered an agent of the taxpayer for two years prior to the exchange or they are considered a disqualified person.
- Real property predominantly used in the United States can only be exchanged for real property used predominantly in the United States. International real property can only be exchanged for real property predominantly used internationally.
- Non resident aliens or foreigners must comply with FIRPTA when selling real estate.

Andy Gustafson, *Certified Exchange Specialist®, serves as a managing member of Atlas 1031 Exchange, LLC, a worldwide accommodator of Internal Revenue Code Section 1031. To date, he has accommodated over 1,250 simple and complex, domestic and international, real and personal property exchanges.*