A Like-Kind 1031 Exchange How to Guide for CPAs

Certified Public Accountants (CPAs) 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 CPAs with a refresher on the 1031 exchange basics, questions to consider, and the steps to a successful 1031 exchange.

1031 Exchange Basics

Timing

In a planning conversation with their clients, CPAs may uncover their client whether the property being listed represents an investment. If so, it is in the mutual interest of the CPA to ask the Seller two questions.

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

If the answer to the second question is “yes” or “maybe”, then, it is suggested the Seller contacts a Qualified Intermediary (QI) to discuss the transactions and steps of a 1031 exchange. Once at the closing and the sale proceeds are given to the Seller, it is too late to initiate an exchange.

Internal Revenue Code 1.1031

The 1031 code applies to real and tangible and intangible personal 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 this tax deferral strategy.

Achieving optimal exchange benefits requires:

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

For some businesses, real property may represent the majority of managed assets while prior to the Tax Cut Jobs Act of 2017, personal property as a whole may have accounted for significant capital investment. Hospitals, medical clinics, research and testing laboratories are prime examples of organizations where fixed assets are routinely depreciated, sold and upgraded with like-kind replacement equipment. Thirteen general asset classes and the North American Industry Classification System (NAICS) are used to match the like-kind, like-class requirement. The cost basis for high technology like medical equipment is depreciated over five years while furniture is over seven years. If the property is sold and replaced, a 25 percent recaptured depreciation tax is triggered. Bonus depreciation raises the tax value because more depreciation was taken in a shorter period of time. The tax consequences can no longer be deferred with a 1031 exchange.

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 (regulations by state are available on the Atlas 1031 web site).

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 equipment. Form 1065, Schedule B, questions 13 and 14 determine whether the title has changed.
- 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 exchanging 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 the 10 percent (of the sale) withholding requirement.
Is the old and new property used predominantly in the United States?

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.

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, 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 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 www.treasurydirect.gov/RI/OFBills. 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. Interest can be shared with the taxpayer for a moderate QI fee, no interest goes to the taxpayer for the lowest fee and all interest is given to the taxpayer for the highest fee.

The QI will discuss the transaction with the taxpayer or designated contact such as the Chief Financial Officer. One of the topics to be discussed is whether they want to use a qualified escrow account (QEA). The QEA provides the best protection for the exchange funds requiring
two signatures to authorize funds disbursement. The taxpayer’s signature must match the notarized signature on file with the bank. The QI principal is the second signature.

**Assignment Language**

Assignment language is often used in the sales contract between the taxpayer and the buyer. The 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 is the QI for the benefit of the taxpayer. Debt, selling and closing expenses are paid with the net proceeds wired to the QEA under the taxpayer’s name and taxpayer 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, 95 percent of what is identified must be acquired. In a forward exchange, the taxpayer can close on the replacement property as soon as 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 property is closed in the first leg, followed by 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 five 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 principal QI as the member. 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 sell to the buyer allowing the taxpayer to
take title to the new property.

Construction and improvement exchanges follow a similar format with the EAT paying vendor
invoices. 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
exchange.

**Benefits**

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

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<th>• Relocation</th>
<th>• Appreciation</th>
<th>• Depreciation</th>
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<td>• Cash Flow</td>
<td>• Diversification</td>
<td>• Consolidation</td>
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**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 to a DST deferring the gain in a failed exchange.
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
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.
Andy Gustafson, Certified Exchange Specialist®, serves as a managing member of Atlas 1031 Exchange, LLC, a worldwide accommodation of Internal Revenue Code Section 1031. To date, he has accommodated nearly 1,400 simple and complex, real and personal property exchanges.