2024 **Title Tenets** Webinar Series

1031 Exchanges in the Commercial Market

Presented by:
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Outline

- Update on President Biden’s Proposal to Cap Section 1031 at $500,000
- Expiration of the Tax Cuts & Jobs Act (TCJA) in 2025
- 1031 Exchange into a DST and later Perform a 721 UPREIT
- Exchange Entities – Who is the Taxpayer?
- Handling 1031 Exchanges of LLCs and Partnerships
- Reverse Exchange “Parking Arrangement” Formats & Activity
- Leasehold Improvement “Parking Arrangement” Format
- Questions and Answers

Proposal to Cap 1031 at $500,000

- This has been proposed by President Biden three years in a row
- The President, Head of the Executive Branch, is just one part of 3 separate government functions
- Tax bills first originate in the House Ways & Means Committee (HW&M)
- Next, a tax bill moves out of the HW&M and is voted on by the House
- The Senate Finance Committee (SFC) works on tax bills in the Senate
- After voting and passing out of the SFC, the Senate votes on a tax bill
- Last, the President signs the tax bill and it becomes law

1031 Industry Studies and Data

Ernst and Young Macroeconomic study found:

- 1031 exchanges support 976,000 jobs annually
- Created $48.6 Billion of labor income
- Added $97.4 Billion to the US GDP
- 1031 exchanges allows for the faster and more efficient redeployment of capital.
- 1031 investments flows to suppliers and businesses that rely on consumer spending such as retail stores, restaurants and entertainment.
- 1031 exchanges encourage businesses to relocate into properties that better meet current and future needs. The promotes the highest and best use of property.

1031 Industry Studies and Data

Ling and Petrova Microeconomic study looked at 1.6 million commercial transactions and determined:

1031 Exchanges are important to a healthy, liquid real estate market

- 20% of all commercial real estate transactions involve 1031 exchanges
- 38% of all CRE exchanges involve multi-family housing

1031 exchanges preserve capital and encourage capital improvement which:

- Create jobs
- Add to state and local tax bases

1031 Exchange buyer invest significantly more capital (15.4%) into replacement property than non-1031 buyers

- Exchange acquisitions are association with:
  Greater equity and lower leverage (30% LTV for 1031 properties compared to 43% for non-1031 acquisitions)
- Reduced credit risk for investors and lenders

1031 exchanges encourage shorter holding periods and improve marketability of illiquid commercial properties.

Expiration of TCJA in 2025

Depends on the outcome of the election and which party is in control of the Executive Branch, the House and the Senate.

Generally speaking, many Republicans have an interest in extending much of the TCJA. The HW&M Committee has broken into working groups looking at all aspects of the tax code and areas to improve.

Generally speaking, many Democrats would be ok retaining the lower tax rates on those making $400,000 or less. Many would like to increase child tax credits and taxes on high earners as well as increase capital gain taxes.

1031 Exchange into a REIT?

No, a taxpayer cannot exchange into shares in a REIT.

REIT shares are personal property and not like-kind real property.

The REIT, at the entity level, can do 1031 exchanges for real property.

However, there is a structure where a taxpayer can:

1) Perform a 1031 exchange into a DST owned by a REIT;
2) Hold the DST interest for generally two years;
3) Perform a 721 UPREIT for OP units in the REIT; and
4) The taxpayer ultimately goes from one asset in one market and acquires OP units in diversified REIT portfolio > diversification.

Delaware Statutory Trusts

What is a typical fractional ownership investment?

Advantages of fractional ownership

Risks involved in fractional ownership

Delaware Statutory Trust (DST): Rev. Rul. 2004-86

Tenant-In-Common (TIC): Rev. Proc. 2002-22

For more information, visit: adisa.org (Alternative and Direct Investment Securities Organization)

Fractional Ownership: DST

Only for an "accredited investor" (a high-net-worth investor as defined in Regulation D of the Securities Act of 1933).

A Delaware Statutory Trust (DST) is a separate legal entity created as a trust under the laws of Delaware in which each owner has a "beneficial interest" in the DST and is treated as owning an undivided fractional ownership in the property.

Chief advantage of a DST is the lender views the trust as only one borrower.

Investors only right to the property is receiving distributions and they have no voting authority regarding the operation of the property.

"Bad boy carve outs" are eliminated and the lender looks to the sponsor for these carve outs from the non-recourse provisions of the loan.

Fractional Ownership: DST vs TIC

	DST STRUCTURE	TIC STRUCTURE
IRS Guidance	Rev. Proc. 2004-86	Rev. Rul. 2002-22
Maximum Number of Investors	No IRS imposed limitation	Up to 35
Ownership	Percentage of beneficial common interest ownership in a DST	Undivided tenant in ownership in a TIC interest in real property
Investors Receive Property Deed	No	Yes
Investors Form Single Member LLC	No	Yes (generally)
Major Decision Approval	No voting rights	Equal voting rights and unanimous approval
Number of Borrowers	1 (the DST)	Up to 35
Bankruptcy Remote	Yes	No/Yes

§1031 - Partnership Issues

A Partnership/LLC 1031 Exchange Scenario: A property is owned by a partnership/LLC. Some partners may want the partnership to stay together and do a 1031 exchange; others may want to do their own separate exchange with their portion of the property; others may want to receive cash and pay the taxes owed.

The fact the partnership owns a capital asset does not mean the partners have an ownership interest in that asset.

The partners merely own partnership interests.

Partnership interests are specifically excluded from Section 1031 under section 1031(a)(2)(D).

Therefore, if a partner wants to exchange, they must convert the partnership interest into an interest in the capital asset owned by the partnership.

§1031 - Partnership Issues

“Drop and Swap” - Involves the liquidation of a partnership interest by distributing an interest in the property owned by the partnership.

After completing the “drop” the former partner will have converted their partnership interest into an interest in the actual property, as a tenant-in-common with the partnership.

The property can then be sold with the former partner and the partnership entitled to do what they wish (sale or exchange) with their respective interests.

§1031 - Partnership Issues

“Swap and Drop” - This alternative involves the same two steps, but in the reverse order.

The partnership completes the exchange (the “swap”) and then distributes an interest in the replacement property to the departing partner.

§1031 - Partnership Issues

Holding Period Issues:

If the “drop” occurs close in time to the “swap” (or visa versa) there may be a question as to whether the relinquished property (or replacement property) was “held for investment.”

If the “drop” occurs too close to the “swap”, the partner’s exchange may be deemed an exchange by the partnership under the *Court Holdings* case.

The more time that passes between the “drop” and “swap” the better.

§1031 - Partnership Issues

Holding Period Issues:

Numerous federal cases (*Bolker, Mason, Maloney*) provide taxpayer-friendly authority against challenges by the IRS.

Some state tax authorities, such as the Franchise Tax Board (FTB) in California, challenge the federal cases and argue they are not bound by the federal cases.

Changes made in 2008 to the federal partnership tax return (IRS Form 1065) make it easier to detect when a drop and swap transaction has occurred, thus making such transactions more vulnerable to challenge by taxing authorities.

§1031 - Partnership Issues

Partnership Installment Note ("PIN"):

An alternative is known as a partnership installment note ("PIN") transaction which results in the gain associated with the "boot" is recognized only by the departing partners. In a PIN transaction, instead of receiving cash, the partnership receives an installment note in the amount necessary to cash out the departing partner(s).

The note is transferred to the departing partner(s) as consideration for their partnership interests. If at least one payment under the note is received in the year following the 1031 exchange, the gain associated with the note is taxed under the IRC Section 453 installment method and recognized only when the actual payments are received by the departed partner(s).

Exchange Entities - General

The same tax owner should take title to the replacement property in the same manner they held title to the relinquished property.

Wife relinquishes, wife acquires

Smith LLC relinquishes, Smith LLC acquires

Gemco Corp. relinquishes, Gemco Corp. acquires

Durst Partnership relinquishes, Durst Partnership acquires

However, having the vesting the same is only a guideline.

The key issue is the ‘tax owner’ of the relinquished property must acquire tax ownership of the replacement property.

Exchange Entities - Exceptions

It is necessary to distinguish between 1) federal tax ownership, 2) state law ownership, and 3) vesting.

A taxpayer who elects taxation as a sole proprietorship (disregarded entity for Federal tax purposes) can sell relinquished property as an individual but acquire replacement property as a single member LLC.

An LLC with two members will be considered a single member LLC if the sole role of the other member is to prevent the other member from placing the LLC into bankruptcy and the limited role member LLC has no interest in profits/losses nor any managing rights.

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Reverse Exchanges & Leasehold Improvement Exchanges

"Parking Arrangement Transactions"

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Parking Arrangements

What is a Reverse Exchange?
Purchase replacement property before the sale of the relinquished property.

What is an Improvement Exchange?
Building a new replacement property from the ground-up or making improvements to an existing replacement property.

What is a Reverse/Improvement Exchange?
Purchase the replacement first and begin construction before closing on the sale of the relinquished property.

What is a Leasehold Improvement Exchange?
Improvements on a 30+ leasehold

Rev. Proc. 2000-37

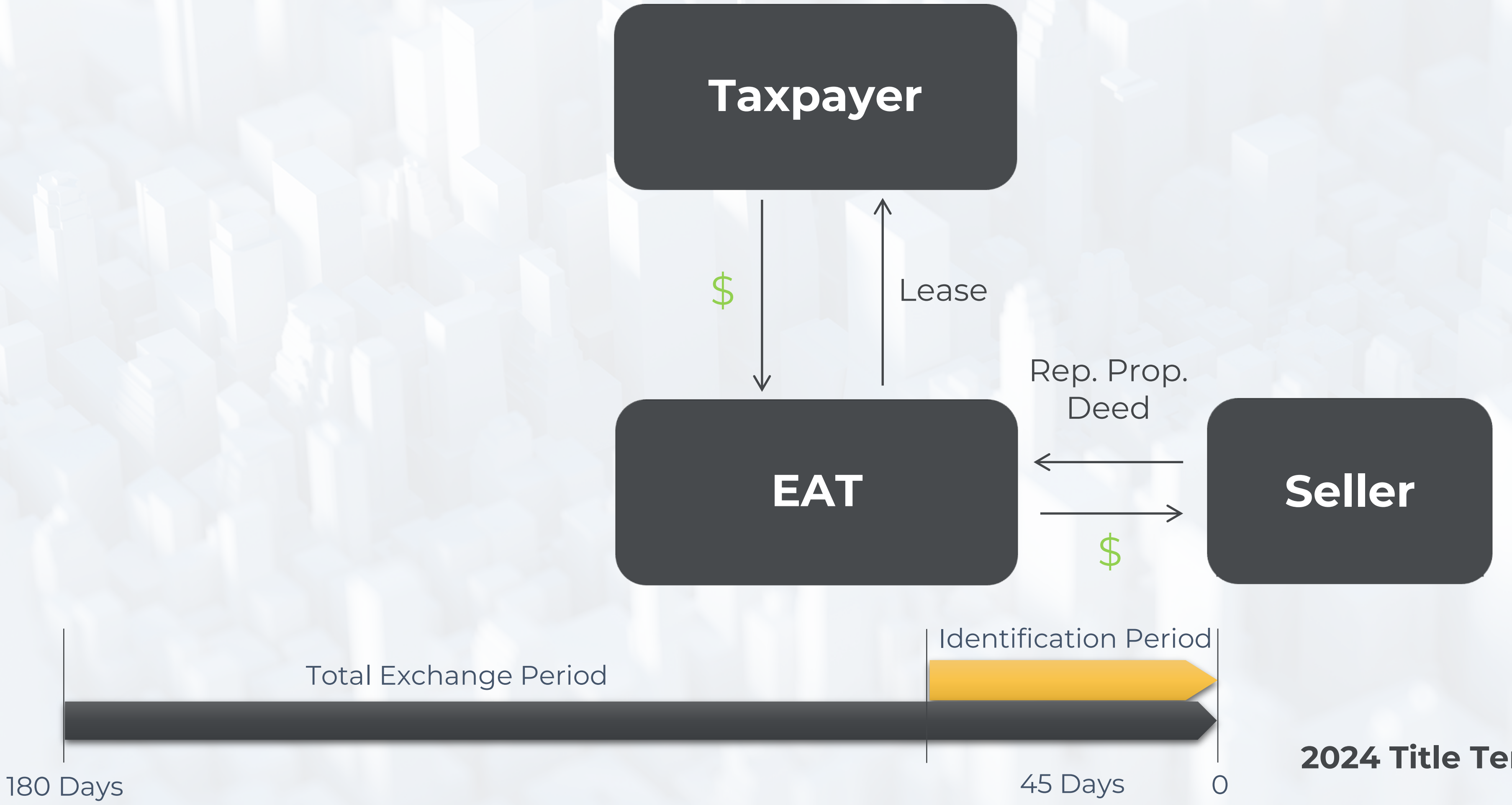
Effective September 15, 2000

Provides a “safe harbor” for reverse exchange transactions that stay within the parameters of the Revenue Procedure.

Reverse exchanges may be structured outside the safe harbor.

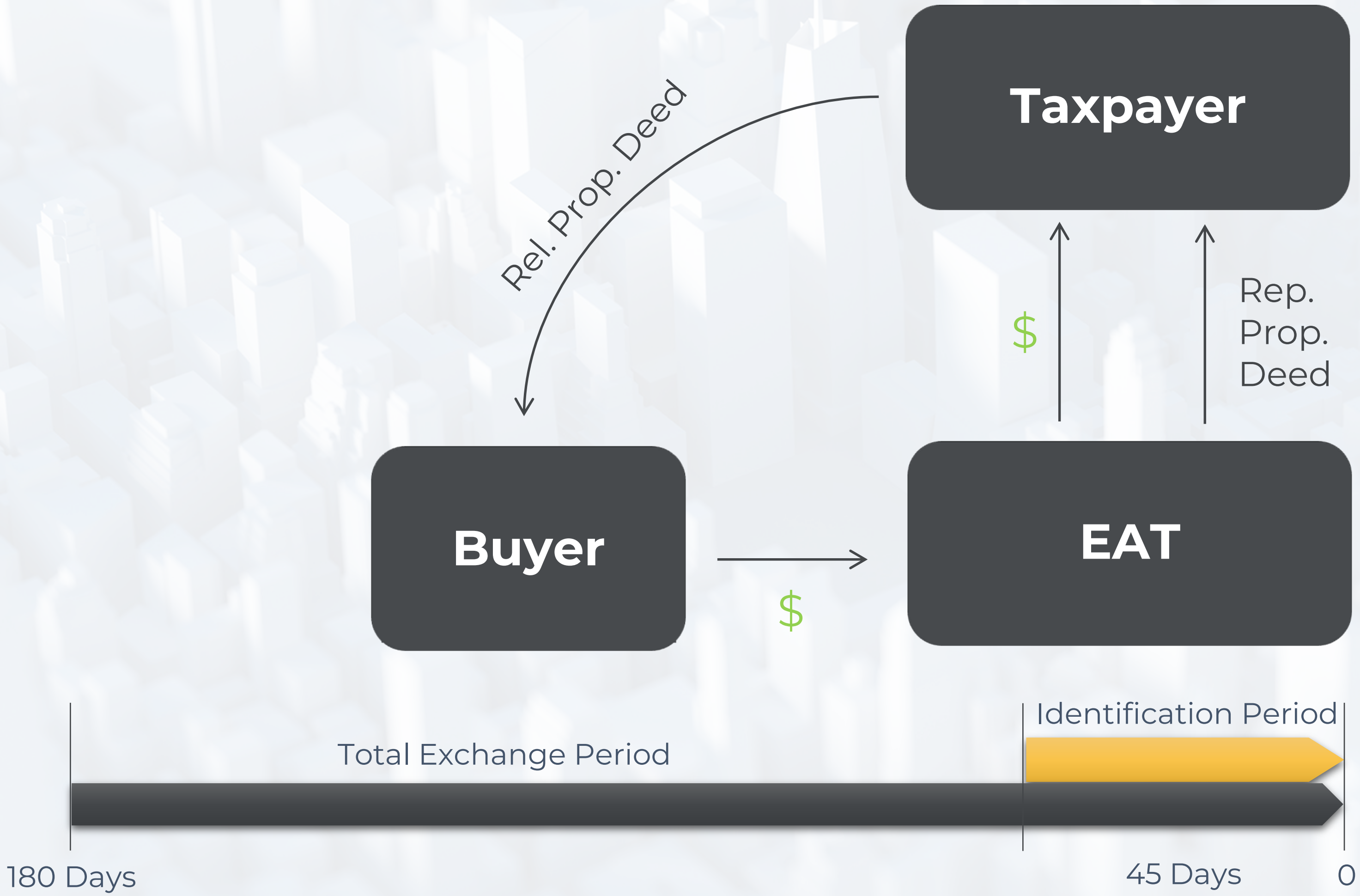
Reverse Exchange – Rep. Parked

Replacement Property Parked (Step 1)



Reverse Exchange – Rep. Parked

Replacement Property Parked (Step 2)



The Reverse Exchange

Parking the Replacement Property

POSITIVES:

Exchange equity does not need to be present

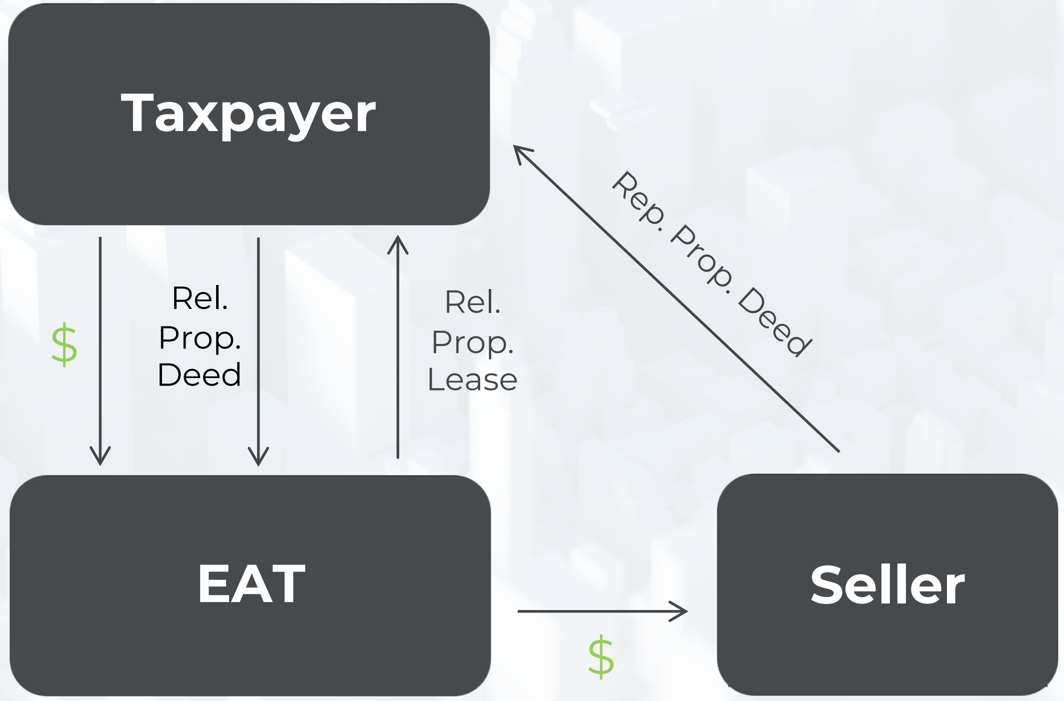
Allows for multiple relinquished properties

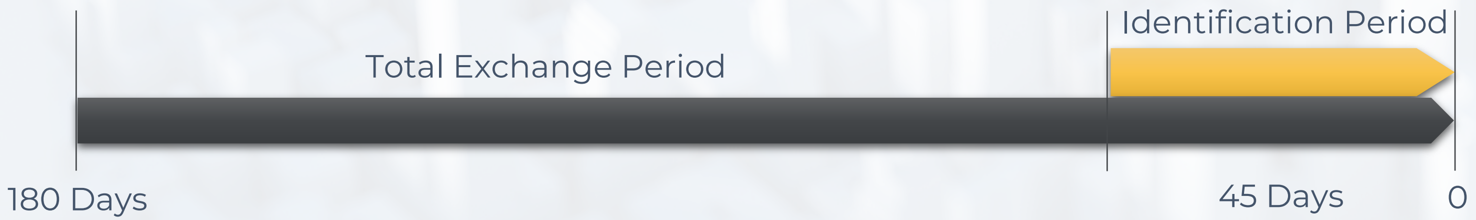
NEGATIVES:

Lender may have issues lending to the Exchange Accommodation Titleholder (EAT)

Reverse Exchange – Rel. Parked

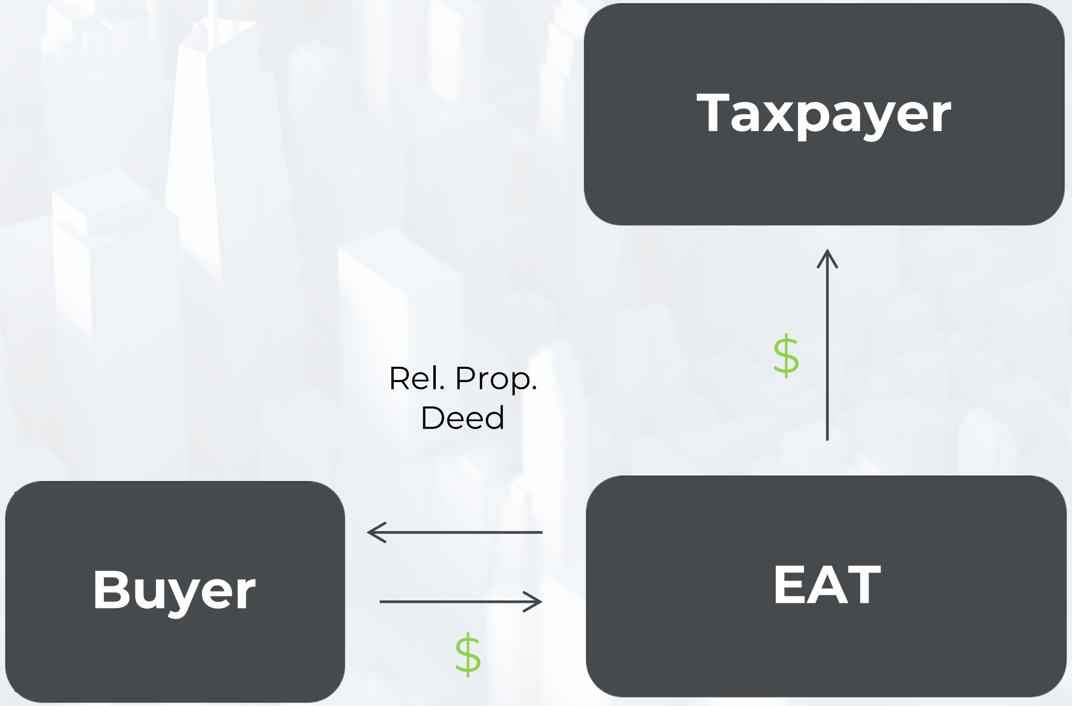
Relinquished Property Parked (Step 1)

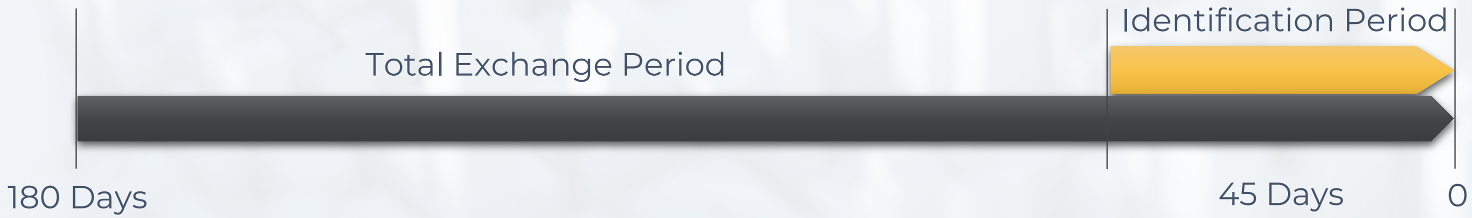




Reverse Exchange – Rel. Parked

Relinquished Property Parked (Step 2)





The Reverse Exchange

Parking the Relinquished Property

POSITIVES:
Loan and purchase easier (direct loan to taxpayer)

NEGATIVES:
Equity and debt should match at the beginning to avoid boot
Lender issues (due on sale)

Revenue Procedure 2004-51

An exchange of real estate owned by a taxpayer for improvements on land owned by the same taxpayer does not meet the requirements of §1031.

See *Decleene v. Commissioner*, 115 T.C. 457 (2000); *Bloomington Coco-Cola Bottling Co. v. Commissioner*, 89 F.2d 14 (7th Cir. 1951). Rev. Rul. 67-225. 1967 2 C. B. 270, holds that a building constructed on land owned by a taxpayer is not of a like-kind to Taxpayer.

Leasehold Improvement Exchange

In a typical improvement exchange, the taxpayer uses a Qualified Intermediary (QI) to sell its relinquished property. An affiliate of the QI, an Exchange Accommodation Titleholder (EAT), uses the proceeds from this sale to purchase a new replacement property from a third-party seller, improve the replacement property, and transfer improved property to the taxpayer within 180 days.

However, the IRS released Private Letter Rulings 200251008 and 200329021 and other PLRs, which set forth structures where an EAT made improvements to a leasehold interest in a property owned by an *affiliate* or *related party* and then the taxpayer received the improved leasehold as qualifying replacement property.

Leasehold Improvement Exchange

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

Leasehold Improvement Exchange

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

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Thank you. Questions?

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