



NAVAGATING AN "EXCHANGING" MARKET
DISCOVER THE VALUE OF §1031 TAX DEFERRED EXCHANGES
IN ALL MARKETS


Presented by:

DINO CHAMPAGNE
DIVISION MANAGER



Outline

- IRC §1031
- Dealer Property / Partnership Issues
- Definition of like-kind property
- The Exchange Equation
- Delayed exchanges
- Parking Arrangements
- 1031 exchanges in a foreclosure
- Qualified Intermediary ("QI") due diligence
- Questions to ask before selecting a QI



Internal Revenue Code §1031

Non-Recognition of Gain or Loss from Exchange Solely of Kind

"No gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like-kind which is to be held either for productive use in a trade or business or for investment."



§1031 - Exceptions

- Stock in trade or other property held primarily for sale
- Stocks, bonds, or notes
- Other securities or evidences of indebtedness or interest
- Interests in a partnership
- Certificates of trust or beneficial interest
- Choses in action



Property Held for Sale

- The purpose for which the property was initially acquired
- The purpose for which the property was subsequently held
- The purpose for which the property was being held at the time of sale
- The extent to which improvements, if any, were made to the property
- The frequency, number and continuity of sales



Property Held for Sale

- The extent and nature of the transaction involved
- The ordinary course of business of the taxpayer
- The extent of advertising, promotion of the other active efforts used in soliciting buyers for the property
- The listing of property with brokers



§1031 – Partnership Issues

- Option #1: (“swap and drop”) Partnership stays intact and acquires replacement property; dissolves later
- Option #2: (“drop and swap”) Election out of the partnership into separate undivided tenant-in-common interests before closing on the relinquished property
- Timing Issues
- Form 1065, the partnership tax return, has two questions on partnership issues in an exchange



Definition of Like-Kind Property

Real Property for Real Property



“LIKE-KIND” PROPERTY



Like-Kind Issues: Holding Period

- Time is only one factor
- The Taxpayer's *intent* is the key issue
- One Perspective: 24 months or more
 - In PLR 8429039, the IRS stated that a minimum holding period of two years would be sufficient.
 - Revenue Procedure 2008-16 ("qualifying use period")
- Second Perspective: Minimum of 12 months
 - Straddles two tax filing years.



Like-Kind Issues: Vacation Homes

Revenue Procedure 2008-16

- Creates safe harbor for vacation home exchanges.
- IRS will consider a dwelling unit held for investment if certain requirements are met.



Requirements:

- The relinquished and replacement properties are owned by the taxpayer for at least 24 months (the qualifying use period);
- Within each of these two 12 month periods constituting the qualifying use period the taxpayer must:
 - Rent the property to another person or persons at fair market rent for 14 or more days (family members qualify if they use the property as the primary residence); and
 - The taxpayer's personal use of the dwelling unit cannot exceed the greater of 14 days or 10 percent of the time it is rented.



The Exchange Equation

For full tax deferral, a taxpayer must meet 2 requirements:

- 1) Reinvest all net exchange proceeds
- 2) Acquire property with the same or greater debt.

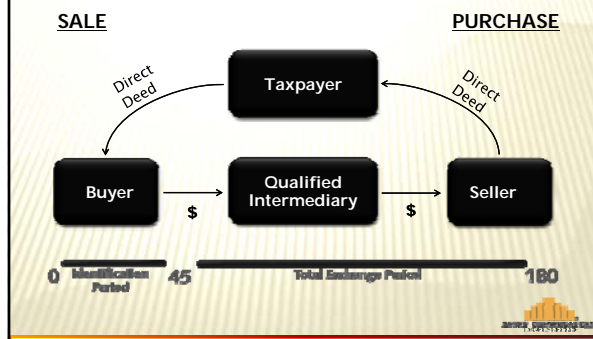
	Relinquished	Replacement	Boot
Value	\$900,000	\$1,200,000	
- Debt	\$300,000	\$660,000	\$ 0
- Cost of Sale	\$60,000		
Net Equity	\$540,000	\$540,000	\$ 0

The taxpayer acquired property of greater value, reinvesting all net equity and increasing the debt on the replacement property.

Analysis: There is no boot.



The Delayed Exchange with a QI



The Delayed Exchange Time Requirements

45 Day Identification Period

180 Day Exchange Period or.....


The Delayed Exchange Identification Rules

- Three Property Rule
- 200% Rule
- 95% Rule

The Delayed Exchange How to Identify Property

Identification must be:

- Made in writing
- Unambiguously describe the property
- Hand delivered, mailed, telecopied or otherwise sent
- Sent by midnight of the 45th day
- Delivered to the Qualified Intermediary or a party related to the exchange who is not a disqualified person




Restrictions on Exchange Proceeds 1.1031(k) - 1(G)(6)

In a deferred exchange, U.S. Treasury Regulations, Section 1.1031(k)-1(g)(6), require stipulations in the exchange agreement which limit the Exchanger's ability to receive, pledge, borrow or otherwise obtain the benefits of money or other property before the end of the exchange period. The Exchanger may have rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property upon or after:

(a) The receipt by the Taxpayer of all replacement property to which the taxpayer is entitled under the exchange agreement

(b) The occurrence after the end of the identification period of a material and substantial contingency that —

- (1) Relates to the deferred exchange,
- (2) Is provided for in writing, and
- (3) Is beyond the control of the Taxpayer and of any disqualified person (as defined in paragraph (K) of this Section), other than the person obligated to transfer the replacement property to the taxpayer."



Parking Arrangements

- Replacement property parked (exchange last)
- Relinquished property parked (exchange first)
- Improvement / build-to-suit exchanges
- Reverse and improvement exchange combined



The Reverse Exchange

Why Perform a Reverse Exchange?

- Seize the moment
- Protect your exchange
- Improve the replacement property
- Safe Harbor vs. Non-Safe Harbor

The Improvement Exchange

Why Perform an Improvement Exchange?

- The property to be acquired in the exchange is not of equal or greater value to property being sold.
- Build a new investment from ground-up.
- The new investment is of equal or greater value, but it needs refurbishments.

Exchanges in a Foreclosure

Sometimes your loss really is your gain!

Taxpayer is faced with the prospect of a short sale or foreclosure because...

- Taxpayer is upside down due to the loan balance exceeding the FMV
- Tenant filing bankruptcy disrupting cash flow
- Unable to meet a capital call

Exchanges in a Foreclosure

Non-Recourse Debt

Taxpayer will recognize capital gain in an amount equal to the total debt secured by the property less taxpayer's adjusted basis.



Exchanges in a Foreclosure

Case Study - Non Recourse

Taxpayer exchanges into a TIC interest valued at \$1.7 million with \$1.2million of debt. Exchange "basis" in the TIC interest is \$300K. Tenant files bankruptcy and owners can no longer meet mortgage obligation. Lender takes back property.

\$1.2 million debt is forgiven, but because the exchange "basis" in the property is \$300K the Taxpayer will realize a \$900K gain. Estimated tax liability \$225K!!!

(Note: Taxpayer received NO cash in this transaction)



Exchanges in a Foreclosure

Recourse Debt: Two Types of Liability

1. Taxable Disposition of Property: Gain or loss recognized. The difference between the FMV of the property and the taxpayer's adjusted basis immediately prior to the disposition.
2. Forgiveness of deficiency if FMV is less than recourse liability: ordinary income to the extent of deficiency (unless excepted)



Exchanges in a Foreclosure

Case Study – Recourse

Taxpayer exchanges into a property valued at \$1.7 million with \$1.2 million of debt. Exchange "basis" in the property is \$300K. Tenant files bankruptcy and owners can no longer meet mortgage obligation. Lender takes back property with a FMV of \$1 million.

\$1.2 million debt is forgiven, but because the exchange "basis" in the property is \$300K the Taxpayer will realize a \$700K gain (FMV \$1M - \$300K basis). Estimated tax liability \$175K!!!

Plus the \$200K of forgiven debt is taxed as ordinary income as a result of the deficiency in the FMV to loan balance. OUCH!!

(Note: Taxpayer received NO cash in this transaction)



Exchanges in a Foreclosure

Exchange must be set up prior to foreclosure or deed in lieu.

- **Foreclosure:** Qualified Intermediary forms LLC to take title prior to foreclosure.
- **Deed in lieu:** Follows same process as a forward exchange.



Exchanges in a Foreclosure

Considerations:

1. Review situation with tax and legal advisor.
2. What are the tax consequences in a short sale, deed in lieu or foreclosure?
3. Communication with lender.
4. Cash to pay tax or deposit on replacement property.



Purchasing a Short Sale or REO As Replacement Property

Purchasing a Short Sale or REO property in an exchange can present some issues:

1. The lender may not allow the "assignment" of the contract to the QI.
2. Some lenders have disallowed the QI from wiring the funds to escrow. They want it directly from the buyer.
3. Will the exchanger meet the exchange timelines?



Purchasing Replacement Property at Auction

Purchasing a replacement property at an auction:

Issues:

1. Typically there is no purchase and sale agreement.
2. There is no escrow.
3. LLC formed to purchase property - Sequential deeding.
4. Must have cashiers check for the purchase price at the auction.
5. The exchanger needs to ID the property(s) within the 45 day ID period.



Transaction Complexities

- Transaction costs
- Investor unable to complete due diligence in a timely manner
- Unable to obtain "clear" title
- The foreclosure process delayed because the borrower files bankruptcy
- No direct authority from the Service



Exchange Trends in 2010

- Sale-leaseback transactions, which can also be structured as exchanges, are increasing as corporations seek other sources of capital from existing assets.
- The energy sector is becoming more popular.
- Solar farms, wind power, alternative energy are attracting new investors.



QI Due Diligence - QI Bankruptcies

Consequences of a QI Bankruptcy

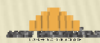
- Inability to complete the exchange
- Proceeds held by the QI are tied up in bankruptcy
- Costly litigation is paid for with the assets of the QI
- No immediate relief from the IRS



QI Due Diligence

Financial Backing


- Does the QI offer customers the written backing of a large creditworthy entity?
- What is the financial rating and balance sheet of this entity?
- Does the QI conduct due diligence on the depositories holding the funds and monitor them?



QI Due Diligence

Financial Backing


- Does the QI offer segregated accounts?
- Does the QI offer a qualified escrow account?
- Does the QI offer a qualified trust account?
- Does the QI have sufficient fidelity bond coverage?



QI Due Diligence

Security Procedures


- Is the QI audited by a recognized external independent auditor?
- What types of internal audit controls are in place?
- Does the QI allow the taxpayer to require notarized signature for the movement of funds?



QI Due Diligence

Security Procedures

- Does the QI have specific written policies for moving exchange funds?
- Does the QI have a written investment policy?
- What security mechanisms are in place to protect against the misappropriation of funds?



QI Due Diligence

Experience

- Will the QI provide a reference and client list?
- If there is a parent company backing the QI, how many years has the parent company been in business?
- What is the level of education and training of the staff?



Contact Asset Preservation, Inc.

Dino Champagne
866.857.1031
310.508.7367

dino@apiexchagne.com

National Headquarters: 800.282.1031
Website: apiexchange.com