

1031 Exchange



Internal Revenue Code Section 1031

§ 1031 - Exchange of property held for productive use or investment

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

1031 Exchange Requirements

Qualified property

Property held for productive use in a trade or business or for investment

Like-Kind

Real Property

All real property located in the United States is like-kind to other real property located in the United States

1031 Exchange Requirements Cont.

Same taxpayer

The taxpayer selling the relinquished property must be the same taxpayer that buys the replacement property

45/180 day time periods

The taxpayer has 45 days to validly identify replacement property

The taxpayer must close on the replacement property by the earlier of 180 days or the due date of the taxpayer's tax return

Documenting the Exchange

Purchase and sale agreement

Should include 1031 cooperation clause

Puts the other party on notice that your client is planning on doing a 1031 exchange

Ensures that CATIC Exchange can take assignment of the P&S

Settlement Statement

CATIC Exchange should be listed as the Seller or the Buyer



Documenting the Exchange Cont.

Deed

The deed should run directly from the Exchanger to the Buyer on the Relinquished Leg and from the Seller to the Exchanger on the Replacement Leg



Partnership Issues

Partnership selling but not all the partners want to do a 1031 exchange

Because of the “Same Taxpayer” requirement if the partnership sold the relinquished property the partners as individuals could not purchase the replacement property

Possible Solution

Drop and Swap Exchange

Drop and Swap

Partnership distributes the relinquished property to the partners or members as tenants-in-common

Former partners or members who desire to do an exchange then sell their individual interest in the relinquished property as part of a 1031 exchange

This structure risks violating the held for “productive use in a trade or business or for investment” requirement

This risk can be minimized by the former partners holding the relinquished property as tenants-in-common for an extended period before the exchange

Flow of Funds

Sale

Deposit can be held by the Exchanger's attorney

Net proceeds should be wired directly to CATIC Exchange from the Buyer's attorney

Purchase

CATIC Exchange will wire the proceeds directly to the settlement agent prior to the sale



Exchange Structures

Forward Exchange

Exchanger sells the relinquished property first, then uses the proceeds to buy the Replacement property

The most common and least complicated of the exchange structures.



Exchange Structures Cont.

Reverse Exchange

Exchanger purchases the replacement property prior to the sale of the relinquished property.

Can be structured two different ways

Replacement Parked Exchange

Relinquished Parked Exchange

Build-to-Suit Exchange

The replacement property is either constructed or will undergo significant capital improvements after acquisition

Reverse Exchange

The Exchanger located the ideal Replacement property and must close before being able to sell the Relinquished property

The Exchanger is running its business out of the Relinquished property and must move its operations to the Replacement property before being able to sell the Relinquished property

Reverse Exchange Cont.

The Exchanger cannot be on title to the Relinquished property and the Replacement property at the same time.

Title to either the Relinquished property or the Replacement property must be “parked” with an Exchange Accommodation Titleholder (“EAT”) in a special purpose entity.

Time Period

- The parked property must be transferred prior to the expiration of the 180 day Exchange Period
- The 180 day period begins when the EAT acquires title to the parked property



Reverse Exchange Disadvantages

Significantly more complex and costly than a forward exchange

- Requires the formation of an SPE

- Filing fees, business entity taxes and insurance expenses

Environmental concerns on Behalf of the QI

Requires more advanced notice in order to properly structure

The Exchanger needs to have the financial ability to purchase the replacement property without the proceeds from the Relinquished property sale

Replacement Parked

The most common and preferred type of reverse exchange structure

The EAT acquires title to the Replacement Property with funds loaned by the Exchanger or a third party lender

The EAT leases the property to the Exchanger

When the Relinquished property is sold, title to the Replacement property is transferred to the Exchanger

Replacement vs. Relinquished Parked

Replacement Parked

When there is a lender involved the EAT is required to be the borrower

Many lenders are unfamiliar with reverse exchanges

Relinquished Parked

The Exchanger needs to loan the EAT an amount equal to the equity in the Relinquished property



Relinquished Parked

The EAT acquires the Relinquished property from the Exchanger

The EAT takes title subject to the existing financing and is loaned the remaining funds by the Exchanger

The funds loaned to the EAT by the Exchanger are used by the QI to acquire the replacement property from the seller

The Replacement property is direct deeded from the seller to the Exchanger

When the Relinquished property is sold the existing debt is paid off and the remaining proceeds repay the Exchanger for the loan to the EAT

Build-to-Suit Exchange

The Exchanger has the opportunity to use exchange funds for construction or capital improvements to the Replacement property



BTS Exchange Cont.

Can be structured as a forward or reverse exchange but title to the Replacement property must be parked

Similar to a reverse exchange, an EAT is created to hold title to the Replacement property during the construction

The Replacement property must be transferred to the Exchanger on the earlier of the end of the 180 day exchange period or completion of construction

BTS Disadvantages

The 180 day time period can be very restrictive

The construction does not need to be completed but the value of the property is determined only with consideration to improvements that have been affixed to the land

Prepaid labor or material does not count

If a construction loan is required, the EAT will have to be the borrower