INTRODUCTION 1031 TAX DEFERRED EXCHANGE

Tax Strategies for Real Estate Investors
Helping to Re-Leverage your Equity

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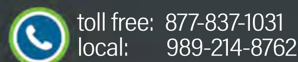
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Alpine Tax Deferred Exchange Co., LLC, cannot provide advice regarding specific tax consequences. Investors considering an IRC § 1031 tax deferred exchange should seek the counsel of their certified public accountant and/or tax attorney to obtain professional and legal advice.

Exchanges are our specialty.

Alpine Tax Deferred Exchange Co., L.L.C. (Alpine 1031) is a national “Qualified Intermediary” serving the real estate community since 1996. In accordance with IRC Section 1031 regulations, Alpine Tax Deferred Exchange Co., L.L.C., (Alpine 1031) is a facilitator under Internal Revenue Code Section 1031.

As a qualified intermediary.

Alpine Tax Deferred Exchange Co., L.L.C. (Alpine 1031) guides you through the entire IRC Section 1031 process. We make certain that you have a complete understanding of the exchange requirements; we prepare all required exchange documentation and manage your funds while the exchange property transactions are pending. Within hours we have the capability to produce and forward the proper exchange documentation anywhere in the United States and there is never a fee for consultation.

Dedicated team of experts.

We offer value-added solutions, ensuring effective management of your exchange to achieve maximum financial benefit. Our exchange program provides the highest levels of customer care, experience, safety and trust you can depend on.

Our goal

We strive to provide you with the necessary tools to make informed decisions regarding your investment strategy. The following pages contain a comprehensive look at the 1031 exchange process, terms and responsibilities of the “Qualified Intermediary” Alpine Tax Deferred Exchange Co., L.L.C., (Alpine 1031) and the taxpayer. This information packet also contains useful forms and guidelines.

Investors considering an IRC § 1031 tax deferred exchange should seek the counsel of their certified public accountant and/or tax attorney to obtain professional and legal advice. To request a presentation or conduct a 1031 class or classes, please do not hesitate to contact us.

For further information or to begin an IRC Section 1031 Tax Deferred Exchange, please contact toll free at 877-837-1031.

Abby Seidel
Vice President, Managing Partner

What is a Tax-Deferred Exchange

Updated March 3, 2021

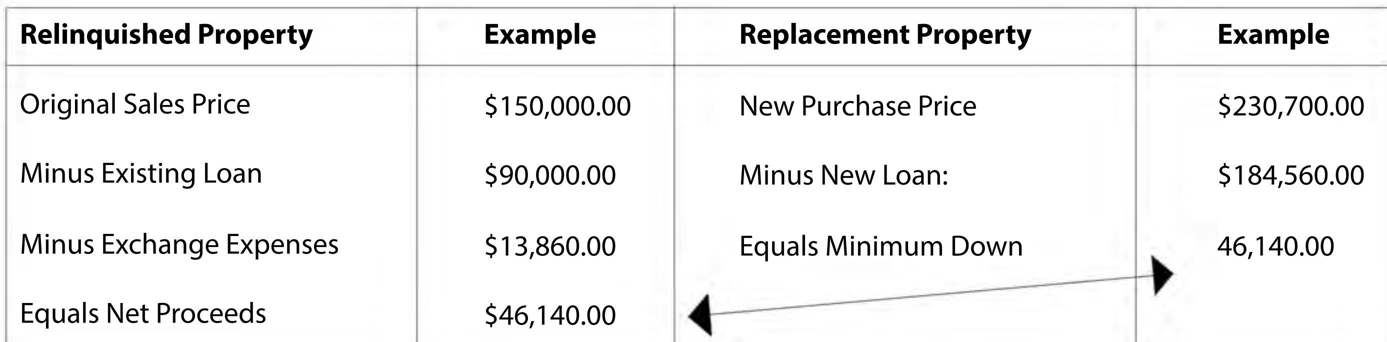
In a typical transaction, the property owner is taxed on any gain realized from the sale. However, through an IRC Section 1031 Exchange, the tax on the gain is deferred until some future date.
IRC Section 1031 provides that no gain or loss shall be recognized on the exchange of property held for productive use in a trade or business, or for investment.

A tax-deferred exchange is a method by which a property owner trades one or more relinquished properties for one or more replacement properties of “like-kind”, while deferring the payment of federal income taxes and some state taxes on the transaction.

The theory behind IRC Section 1031 is that when a property owner has reinvested the sale proceeds into another property, the economic gain has not yet been realized in a way that generates funds to pay any tax. In other words, the Exchanger/Taxpayer’s investment is still the same; only the form has changed (e.g. vacant land exchanged for a duplex). Therefore, it would be unfair to force the taxpayer to pay tax on a “paper” gain.

The like-kind exchange under IRC Section 1031 is tax-deferred, not tax-free. When the replacement property is ultimately sold (not as part of another IRC Section 1031 Exchange), the original deferred gain, plus any additional gain realized since the purchase of the replacement, is subject to gain.

What are the general guidelines to follow for an Exchanger/Taxpayer to defer all taxable gain?
To fully defer state and federal capital gain taxes, the value of the replacement property must be equal to or greater than the value of the relinquished property. The equity in the replacement property must be equal to or greater than the equity in the relinquished property. The debt on the replacement property must be equal to or greater than the debt on the relinquished property. All the net proceeds from the sale of the relinquished property must be used to acquire the replacement property.



Relinquished Property	Example	Replacement Property	Example
Original Sales Price	$150,000.00	New Purchase Price	$230,700.00
Minus Existing Loan	$90,000.00	Minus New Loan:	$184,560.00
Minus Exchange Expenses	$13,860.00	Equals Minimum Down	46,140.00
Equals Net Proceeds	$46,140.00		

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TAX DEFERRED EXCHANGE

Calculation Examples

Before selling your income or investment property, contact your legal or tax advisor to do the math.

Example: Let's assume you have a sales price of $250,000.00 with a loan of $100,000.00 and the property was originally purchased for $150,000.00 plus you put a new roof on the dwelling. You purchased the property 2 years ago for investment purposes.

Calculate Net-Adjusted Basis:	Adjusted basis is equal to the purchase price, plus capital improvements, less depreciation	**Example**
Original Purchase Price	This is what you paid for the property	$150,000
Plus Capital Improvements	Installed a new roof	$10,000
Minus Depreciation taken (Based on Residential Prop.)	$160,000 ÷ by 27.5 yrs = $5,818 per year x 2yrs	($11,636)
Equal Adjusted Basis	Starting point of gain or loss of property	$148,364
Calculate Capital Gain:	Capital gains is the difference between the sales price of relinquished property -less selling expenses and adjusted basis	**Example**
Current Sales Price	This is what you are selling the property for	$250,000
Minus Exchange Expenses	Closing Cost approx. 7.750% of Sales Price	($19,375)
Minus Adjusted Basis	Starting point of gain or loss During the time you own the property	($148,364)
Equals Capital Gain	Difference between sales price, less closing costs and adjusted basis	$82,261
Calculate Capital Gain Tax	Herein Below is what you will pay on depreciation, federal and state taxes	**Example**
Gain Due to Deprecation Recapture	Depreciation $11,636 x 25% Recapture =	$2,909
Plus Federal Capital Gain Tax - Depreciation	$82,261- $11,636 = $70,625 x 15% Capital Gains – Depreciation = X Federal	$10,593
Plus State Capital Gain Tax	Approx. 4.35% x $82,261 =	$357.83
Total Combined Tax Due	Amount you pay if you do "not" effect an IRC Section 1031 Tax Deferred Exchange	**$13,859.83**

The formula set forth above is provided to help you determine your approximate gain and the sums that you may wish to defer through your exchange transaction. Consult with your tax advisor to determine the correct values and whether an exchange is appropriate for your circumstances.

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Retirement Strategy

Exclude and Exchange Capital Gain Combining IRC § 121 and § 1031

On February 4th, 2005 the Internal Revenue Service issued Revenue Procedure 2005-14 ("Rev. Proc. 2005-14") providing guidance on the application of §121 (the Personal Residence Exemption) and §1031 (the Tax Deferred Exchange). IRC §121 permits an exclusion from capital gain realized of $250,000 for a single person and $500,000 for a married couple on the sale of a home used as a primary residence for any two of the past five (5) years. IRC §1031 permits the deferral of capital gain realized by exchanging property held in a trade or business or for investment for like kind property of equal or greater value.

Obviously ones primary residence will not qualify for a §1031 exchange, but if the residence is converted to a rental for two years, it will qualify for a §1031 exchange as property used in a trade or business. Thus it is possible under Rev. Proc. 2005-14 to both exclude capital gain under §121 and defer capital gain in an exchange under §1031.

Retirement Case Study

Mark bought a residence for $220,000 in June of 1997 and lived in it until June 2003. Then his company transferred him to a new division. He rented the home for two (2) years from June 2003 to June 2005. Now he's ready to retire and is looking at condos – no yard work and time to golf. He has found an association with a pool, clubhouse and golf course – all for $600,000. His Realtor say he'll get $880,000 for his house. Wow! Mark has no debt (Mortgage) on his house so after closing cost he'll pocket net proceeds of $820,000. He spends evenings surfing exotic travel destinations. Life is great!

Then Mark and his son visit a CPA who calculates his capital gain. Mark bought his house for $220,000. Over the years he invested $100,000 in improvements and for the two years he rented the property took total depreciation deductions of $16,000. His adjusted cost basis is $304,000. ($220,000 purchase price plus $100,000 improvements minus $16,000 depreciation taken). His capital gain equals $516,000. (Sales Price of $880,000 minus his adjusted basis of $304,000 and minus $60,000 closing costs). IRC §121 does not exclude depreciation recapture after May 6th, 1997 so the first $16,000.00 of capital gain will be taxed at 25% federal and 7.25% for the state of Hawaii where his property is located. The balance will be taxed at 15% federal and 7.25% Hawaii state tax. Mark's CPA tell him that he will need to write checks to the IRS and the State totaling $126,988. Mark begins to "**hyperventilate**".

His CPA tells him to calm down. IRC §121 provides a $250,000 exclusion from gain to individuals who owned and used a home as their principal residence two (2) of the past five (5) years. So, Mark snatches the calculator from his accountant and reduces the gain from $516,000 to $266,000. Mark now owes a capital gains tax of $66,238. "I don't want to pay $66,238 in taxes." "**He wails**."

His CPA points out that since he has rented the house for the past two (2) years, converting it to property used in a trade or business, it is eligible for a IRC §1031 exchange into replacement property used in a trade or business or held for investment. If he purchases replacement property worth $570,000 ($880,000 minus $60,000 closing costs minus the $250,000 IRC §121 exclusion therefor excluded) he will defer all his capital gain and avoid depreciation recapture. Mark smiles brightly as he realizes by excluding under IRC §121 and exchanging under IRC §1031, he can retain his entire net sale proceeds of $820,000. His CPA suggests that for replacement property he purchase $570,000 in a Tenancy In Common (TIC) that will generate a stream of income in his

retirement years without the headaches of property management (The CPA notes to Mark that on Mark's death the basis in the replacement property will be stepped up to fair market value, allowing Mark's son to avoid all capital gain upon his disposition at that time.) Moreover, Mark can take $250,000 cash out at the close of escrow on his house without paying either state withholding or capital gains tax. He can put 20% down payment on his condo of $120,000. He income stream from his TIC investment will offset his mortgage payment. He'll still have $130,000 cash to pocket toward his retirement. Mark again daydreams of exotic travel destinations.

But, Mark is skeptic. He leans forward and asks if this is legal. His CPA hands him a copy of Rev. Proc. 2005-14 on the application of IRC §121 and IRC §1031 to a single exchange of property. Mark's son, Greg, has been listening intently to everything the CPA has explained to Mark and wonders if he can also take advantage of Rev. Proc. 2005-14. Greg explains to the CPA that he acquired a rental house in June 2001 as his replacement property in an IRC §1031 exchange. He rented the house to a tenant for a year. When the tenant moved out he was unable to find another renter so he moved in for two (2) years and made improvements. He then moved out and was able to again rent the newly renovated house for one (1) year through June 2005. Now Greg decides that he, too, wants to sell and elect IRC §121's $250,000 exclusion and do another IRC §1031exchange into a new replacement property that will have a better cash flow. The CPA tells him this will not be possible because his rental property was acquired in a IRC §1031 exchange and, therefore, the IRC §121 exclusion is not available until the taxpayer (Greg) has both lived in the property as his principal residence for two (2) of the past five (5) years and owned the property for a total of five (5) years. This means Greg must hold the rental one (1) more year until June 2006 to sell it and execute the combined exclude and exchange strategy under IRC §121 and IRC §1031. Gregg is depressed, but Mark assures him that with age comes both wisdom and patience. Greg sees that things aren't so bleak after all and agrees that it is worth waiting one more year in order to have $250,000 tax free.

Should you have any questions please do not hesitate to contact me at your earliest convenience.

Impact of the New 2018 Tax Law on Real Estate Owners

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The focus of this article is to provide an overview of the new tax law, formerly referred to as The Tax Cuts and Jobs Act, and the impact on both residential property owners as well as investment property owners. The scope of this overview focuses on real estate-related tax law changes and generally does not delve into tax issues not associated with real estate.

Primary Residence Homeowners

As a result of doubling the standard deduction to $12,000 for single filers and $24,000 for married filing jointly, according to Moody's Analytics, as many as 38 million Americans who would otherwise itemize may instead choose the higher standard deduction under the new tax plan. The doubling of the standard interest deduction, in essence, removes a tax incentive of moving from renting a home to home ownership and a likely outcome will be fewer Americans choosing to become homeowners versus renters solely for the tax advantages.

Any home mortgage interest debt incurred before December 15, 2017, will continue to be eligible for the home mortgage interest deduction up to $1,000,000. Any home mortgage interest debt incurred
after this date will be limited to no more than $750.000 qualifying for the home mortgage interest deduction. Beginning in 2018, the deduction for interest paid on a home equity line of credit ("HELOC") will no longer be eligible for the home mortgage interest deduction. However, the new tax law preserves the deduction of mortgage debt used to acquire a second home which should have a positive impact on supporting property values in resort and vacation destinations.

State and local taxes (referred to collectively as "SALT") can be deducted but will no longer be unlimited as under current tax law. The 2018 tax law will allow homeowners to deduct property taxes and either income or sales taxes with a combined limit on these deductions being limited to no more than $10,000. The top earners who live in high state tax like California, Connecticut, Oregon, Massachusetts, New Jersey, New York and other states will be negatively affected the most by no longer having the previous full federal deduction available. There is the potential for home values in high state tax areas on both the West and East Coast to see a reduction in property values. A National Association of REALTORS™ study determined there could be a drop in home prices up to ten (10) percent in these and other high state tax areas.

Both the House and Senate tax bills had originally proposed increasing the length of time a homeowner would need to live in primary residence (from five out of eight years versus the current requirement to live in a primary residence two out of five years to qualify for the Section 121 tax exclusion.) This proposed change did not become a part of the 2018 tax law. Homeowners will continue to only need to live in their primary residence twenty-four (24) months in a sixty (60) month time period to be eligible for tax exclusion up to $250,000 if filing single and up to $500,000 if married filing jointly. Property owners will still have the ability to convert a residence into a rental property or convert a rental property into a residence and qualify for tax exclusion benefits under both the primary residence Section 121 rules and also potentially qualify for tax deferral on the rental property under Section 1031.

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Impact of the New 2018 Tax Law on Real Estate Owners

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Investment Property Owners

Investment property owners will continue to be able to defer capital gain taxes using 1031 tax-deferred exchanges which have been in the tax code since 1921. No new restrictions on 1031 exchanges of real property were made in the new tax law. However, the new tax law repeals 1031 exchanges for all other types of property that are not real property. This means 1031 exchanges of personal property, collectibles, aircraft, franchise rights, rental cars, trucks, heavy equipment and machinery, etc. will no longer be permitted beginning in 2018.

Some investors and private equity firms will not have to reclassify "carried interest" compensation from the lower-taxed capital gains tax rate to the higher ordinary income tax rates. However, to qualify for the lower capital gain tax rate on “carried interest” investors will now have to hold these assets for three (3) years instead of the former one (1) year holding period.

Some property owners such as farmers and ranchers and other business owners will receive a new tax advantage with the ability to immediately write off the cost of new investments in personal property which is more commonly referred to as full or immediate expensing. This new provision is a part of the tax law for five (5) years and then begins to taper off later on. There are significant concerns these business and property owners will face a “tax cliff” and higher taxes once the immediate expensing provision expire.

Reduced §121 Gain Exclusion
IN SOME CIRCUMSTANCES

Internal Revenue Code (IRC) Section 121 permits a taxpayer to exclude gain in the amount of $250,000 or $500,000 for married couples filing jointly on the sale of the a principal residence. A residence is a principal residence if the taxpayer has owned and used the residence as the taxpayer's residence for any two (2) years during the five year period ending on the date the residence is sold. The Housing Assistance Tax Act of 2008, signed by President Bush on July 30, 2008, amends §121 and may reduce the exclusion available to taxpayers who initially acquired the principal residence in a §1031 tax deferred exchange or used the property as a rental property before converting the rental property into a principal residence. As of January 1, 2009, the exclusion must be allocated between the period the principal residence was used as an investment property or second home, and the period of time the residence was used as the taxpayer's principal residence. Any portion of the exclusion amount that is allocated to the period the property is not used as the taxpayer's principal residence is eliminated.

How does this change affect §1031 tax deferred exchange planning? Suppose a single taxpayer exchanges into a rental property which is rented for four (4) years, and then moves into this former property and lives in it for two (2) years as a principal residence. The taxpayer then sells the principal residence and realizes $300,000 of gain. Under prior tax law, the taxpayer would be eligible for the full $250,000 exclusion and would pay tax on the $50,000 remainder. Under the new law, the exclusion would have to be prorated as follows (Note: This example does not take into account deprecation taken after May 1997, which is taxable at 25%).

- Two-thirds (4 out of 6 years) of the gain, or $200,000, would be ineligible for the $250,000 exclusion.

- One-third (2 out of 6 years) of the gain, or $100,000, is eligible for the exclusion. [This example was changed to show that the allocation formula takes into account years before the 5 year lookback period in §121(a).]

Non-qualified use prior to January 1, 2009 is not taken into account in the allocation for the non-qualified use period (but is taken into account for the ownership period). Suppose the taxpayer had exchanged into the property in 2007, and rented for 3 years until 2010 prior to the conversion to a principal residence. If the taxpayer sold the residence in 2013, after three years as a principal residence, only the 2009 rental period would be considered in the allocation for the non-qualified use. Thus, only one-sixth (1 out of 6 years) of the gain would be ineligible for §121 tax exclusion.

In general, the allocation rules only apply to time periods prior to the conversion into a principal residence and not to time periods after the conversion out of principal residence use. Accordingly, if a single taxpayer converts a principal residence into a rental property and never moves back in, and otherwise meets the two out of five year relinquished under §121, the taxpayer is eligible for the full $250,000 exclusion when the rental property is sold. This rule only applies to non-qualified use periods within the 5 year lookback period of §121 after the last date the property was used as a principal residence. Therefore, if the taxpayer used the property as a principal residence in year one and year two, then rented the property for years three and four, and then used it as a principal residence in year five, the allocation rules would apply and only three-fifths (3 out of 5 years) of the gain would be eligible for the exclusion under §121.

Related-Party Like-Kind Property Exchanges: Recent IRS Guidance

By Nancy B. Nichols, Jill Mayclim, and M. Cathy Sullivan

In 2002, the IRS issued new guidance for related-party like-kind exchanges using a qualified intermediary. Revenue Ruling 2002-83 (2002-49 IRS 927, 11/25/2002) eliminated the opportunity for related parties to exchange property using a qualified intermediary (QI) when, as part of that transaction, one of the related parties receives cash or other non–like-kind property in the exchange. This ruling becomes yet another obstacle for like-kind exchange transactions between related parties that are already subject to other restrictions.

Like-Kind Exchanges

Generally no gain or loss is recognized on the exchange of like-kind property. Like-kind property is defined as property held for productive use in a trade or business or for investment that is exchanged solely for similar property. The basis of the property acquired is the same as the basis of the property exchanged, decreased by any boot (property other than like-kind) received and increased (or decreased) by the gain (or loss) recognized by the taxpayer. (See "Like-Kind Real Estate Exchanges Under IRC Section 1031," The CPA Journal, November 2001.)

Related-party restrictions.

As part of the Omnibus Budget Reconciliation Act of 1989, Congress enacted additional requirements for like-kind exchanges between related parties [IRC section 1031(f)]. The additional rules are intended to eliminate the benefits that related parties were receiving by exchanging low-basis property for high-basis property in anticipation of the profitable sale of the low-basis property.

To avoid this "shifting of basis," IRC section 1031(f) requires a two-year holding period after an exchange between related parties. If either the taxpayer or the related party disposes of the exchanged property within two years, then the taxpayer's exchange with the related party becomes taxable.

Related party defined.

For purposes of the like-kind exchange rules, the definition of related parties is a combination of related parties as defined under IRC section 267(b) and section 707(b). Combining these two sections, related parties include the following:

- Family members (siblings, spouses, ancestors, and lineal descendants);
- An individual and an entity (corporation or partnership) where the individual owns either directly or indirectly more than 50% in value of the entity;
- Two entities in which the same individual owns directly or indirectly more than 50% of each;
- An estate in which the taxpayer is either the executor or beneficiary of the estate; and
- A trust in which the taxpayer is the fiduciary and the related party is a beneficiary either of that same trust or a related trust or a fiduciary of a related trust.

Two-year holding period.

IRC section 1031(f) created a two-year holding period for property given up or received in a like-kind exchange between related parties. The nonrecognition treatment under section 1031 is lost if either property in the exchange is disposed of within two years. Thus, if either the taxpayer or the related party disposes of the property received in the exchange within two years, the gain or loss is triggered for both parties. Section 1031(f) does not bar related-party exchanges, it merely requires a longer holding period to deter taxpayers from shifting low-basis property with high-basis property in anticipation of selling the low-basis property, thus substantially reducing the amount of gain recognized on the transaction.

Related-Party Like-Kind Property Exchanges: Recent IRS Guidance

By Nancy B. Nichols, Jill Mayclim, and M. Cathy Sullivan

Related parties often overlook the "suspension" provisions in IRC section 1031(g) that can extend the two-year holding period. The two-year holding period is suspended if either the taxpayer's or the related party's risk of loss is substantially decreased (due to an option, put, or other transaction). Once the risk of loss ceases, the two-year period continues from the point where it stopped.

For example, Taxpayer exchanges property with Related Party. Twelve months later, Third Party acquires an option to acquire the property from Related Party. The option expires 12 months later and Related Party waits seven months and sells the property. Even though the sale is 31 months after the original exchange, Taxpayer's gain from the original exchange is triggered, because the two-year holding period was suspended during the time the option was outstanding, so the sale is deemed to occur only 19 months after the exchange.

Additional exceptions exist to the two-year holding period. Under IRC section 1031(f)(2), if the taxpayer or related party dies and the property is disposed of within the two-year holding period, gain will not be triggered to the second party. In addition, the two-year limitation will not apply if the property is disposed of due to an involuntary conversion and the original exchange occurred before the threat or imminence of such conversion. The third exception provides that if the taxpayer can establish that neither the original exchange nor the subsequent disposition within the two-year period was undertaken for the purpose of avoiding tax, then the original exchange will not fail.

The IRS has provided guidance regarding the third exception in two letter rulings. In PLR 9116009, the IRS held that a taxpayer's transfer of property acquired in a like-kind exchange with a related party to a grantor trust within two years of the exchange is not a disposition under section 1031(f). The second letter ruling, PLR 199926045, involves the cutting of timber on the replacement property received in a like-kind exchange from a related party. Here, the IRS ruled that the taxpayer's original exchange remained intact and that the subsequent cutting of timber by a related party within the two-year period did not trigger a gain to the taxpayer.

Anti-abuse Provision

IRC section 1031(f)(4) provides that deferred treatment is denied in any exchange that "is part of a transaction (or series of transactions) structured to avoid" the purpose of the related-party rules. This catchall provision causes many exchanges to fail and is often misunderstood or overlooked.

Recent IRS guidance.

Application of the anti-abuse provision with the use of a qualified intermediary in a related-party like-kind exchange has resulted in a number of IRS rulings, most recently Revenue Ruling 2002-83 (2002-49 IRS 927, 11/25/2002). This ruling prevents related parties from deferring recognition of gain by using a qualified intermediary when the related party receives cash or non–like-kind property.

For example, Bob owns Property 1 worth $100 with a basis of $10, and his brother Jim owns Property 2 worth $100 with a basis of $100. Jane, an unrelated party, wants to acquire Property 1 for $100. To complete the transfer, Bob enters into an agreement to exchange Property 1 and 2 with Jim, Jane, and a qualified intermediary (QI) unrelated and independent of Bob and Jim. Bob transfers his low-basis Property 1 to QI; QI then exchanges Property 1 with Jane for cash; QI attains high-basis Property 2 from Jim for cash, and transfers Property 2 to Bob.

Bob has engaged in a like-kind exchange with QI (an unrelated third party) instead of with Jim. Essentially, the result of the transaction, if one removes the QI, is as follows: Bob and Jim have exchanged properties, and Jim sold the property received in the exchange to Jane for cash. According to the ruling, a related party is not entitled to nonrecognition treatment under section 1031 if the related party receives cash or other non–like-kind property for the property received in a transaction that uses a QI to exchange the property. In this example, Jim has received non–like-kind property (cash); thus, the provisions of 1031 will not apply, and Bob must recognize his gain of $90.

In making the ruling, the IRS relied on the anti-abuse provision of IRC section 1031(f)(4), holding that the QI was used to circumvent the purpose of the related-party rules and, therefore, the nonrecognition provisions of section 1031 do not apply. In Technical Advice Memorandum (TAM) 9748006 (11/28/1997), the IRS used the same approach for analyzing a like-kind exchange involving related parties, a QI, and an unrelated third party. In general, the IRS looks to the final outcome to determine whether a related party "cashed out." If a related party has cashed out, then the transaction will not qualify for nonrecognition treatment under section 1031.

TAM 2001-26007 involves a complicated set of transactions between two corporations meeting the related-party definition due to common stock ownership by members of two families. The transactions involved a QI and two unrelated parties. Ultimately, the transactions shifted the taxpayer's low basis in its property to the replacement property previously owned by the related party. The related party eventually received cash that it used to reduce bank debt. In the end, the related party "cashed out" of its investments, denying the taxpayer nonrecongition treatment on the transactions.

Field Service Advice (FSA) Memorandum 2001-37003 provides that if related parties exchange properties, nonrecognition treatment of the gain is permitted as long as the subsequent disposition of the replacement property occurs after two years of the initial exchange. The IRS concluded "the two-year rule in section 1031(f)(1)(C) is a safe harbor that precludes application of section 1031(f)(1) to any transaction falling outside that period." Therefore, related parties can avoid the anti-abuse rules just by waiting two years. The FSA states that the purpose of the anti-abuse provisions is to "stop taxpayers from violating the two-year rule, and not to preclude taxpayers from planning to dispose of property after the two-year period." Taxpayers can enter into a related-party exchange with the intent of selling the property after two years without triggering recognition of the original gain as long as the transaction was not a sham.

Planning Considerations

The restrictions and potential pitfalls of related-party like-kind exchanges would seem to limit the tax benefits of these transactions. The opportunity for tax deferral, available for all like-kind exchanges, still applies to related-party transactions. In many situations, tax deferral coupled with estate planning objectives make related-party like-kind exchanges very attractive.

From an estate planning perspective, like-kind exchanges may result in taxes never being paid on the investment. If a taxpayer who has participated in a section 1031 exchange dies, the property is left to heirs without being subject to capital gains tax. Properties are revalued when the taxpayer dies, and the accumulated capital gains that were never recognized are wiped clean.

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By Nancy B. Nichols, Jill Mayclim, and M. Cathy Sullivan

Other estate planning objectives can also be accomplished through like-kind exchanges. For example, retiring parents with a family farm may exchange the farm for smaller real estate parcels that are investments owned by their children. These smaller parcels can then be gifted back to the children over time. Or the parents may retain ownership of the properties and sell them over a period of years, after the two-year holding period has been met. This plan would give the retired couple additional funds in retirement by allowing them to control when and how much gain they realize.

If the children do not have investment properties that meet the parents' needs, a multiparty exchange may be the answer. As long as the parents and children do not cash out for two years, the nonrecognition provisions under section 1031 will still apply.

The shifting of basis still works for related parties, but requires a little more work. For example, a taxpayer who owns a property with low basis that has appreciated significantly can still consider exchanging the property with a related party that owns investment property with a higher basis. As made clear in FSA 2001-37003, the related parties can avoid the anti-abuse provision by waiting two years to sell the property. This technique works especially well in the following situation: A parent owns investment land that is appreciating significantly. The area where the land is located is beginning to develop and the parent knows that the property will eventually be sold. A child has rental property that generates income but is not appreciating as rapidly. The child does not need the rental income and the parent could use the income to supplement his retirement. A like-kind exchange is ideal. Not only will the tax on the ultimate sale be lower because of the child's higher basis, but also the additional appreciation during the two-year holding period will have been transferred to the child.

Reporting requirements.

IRS Form 8824, Like-Kind Exchanges, must be filed when an exchange involving like-kind property occurs. When related parties exchange property, additional information is required, including the name, address, identifying number, and relationship of the related party. In addition, Form 8824 must be filed for the year of exchange and also for the two years following the exchange to provide the IRS with the information necessary to monitor the two-year holding requirement.

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Vacation Homes Finally Defined

Effective March 10th, 2008

REVENUE PROCEDURE 2008-16, creates a safe harbor definition of investment property applicable to exchange transactions closing after March 10, 2008 that involve the transfer of property consisting of a dwelling unit and/or the acquisition of a dwelling unit as replacement property. In short, the IRS will not challenge whether a residential property or vacation home property is held for productive use in a trade or business or for investment if certain specified ownership and use requirements are met. The safe harbor procedure provides useful guidance on the characterization of vacation property and may also be useful for planning purposes such as the conversion of a principal residence into a qualifying relinquished property.

REQUIREMENTS OF REVENUE PROCEDURE 2008-16

A dwelling unit is defined as any real property improved with a house, apartment, condominium, or similar improvement that provides basic living accommodations including a sleeping space, bathroom and cooking facilities (e.g., a residential property).

The IRS will not challenge whether a dwelling unit qualifies as Section 1031 exchange property held for productive use in a trade or business or for investment if: (1) the relinquished property is owned by the taxpayer for at least 24 months immediately prior to the exchange and a replacement property is owned for at least 24 months immediately after the exchange (the "qualifying use period") and (2) within each of the two 12 month periods constituting the qualifying use period, the taxpayer must:

(a) Rent the property to another person or persons at a fair rental for 14 or more days; and
(b) The taxpayer's personal use of the dwelling unit cannot exceed the greater of 14 days or 10 percent of the number of days during the 12 month period the dwelling unit is rented at a fair rental.

Under the Procedure, personal use of a dwelling unit occurs on any day in which the taxpayer is deemed to use the property for personal purposes under Section 280A(b)(2) (taking into account Section 280A(b)(3) but not Section 280(b)(4)). Thus, personal use includes:

(1) use by the taxpayer or any other person who has an interest in the property or by a family member (2) use by any individual who uses the unit under an arrangement which enables the taxpayer to use some other dwelling unit (whether or not a rental is charged for the use of such other unit; or (3) use by any other individual if rented for less than fair market value. A taxpayer can rent the property to a family member if the family member uses the property as a primary residence and the family member pays fair market rent. Whether a dwelling unit is rented at a fair rental is determined based on all the facts and circumstances that exist when the rental agreement in entered into. All rights and obligations of the parties to the rental agreement are taken into account.

LIMITED APLLICATION OF SAFE HARBOR: The safe harbor provided in this revenue procedure applies only to the determination of whether a dwelling unit qualifies as property held for productive use in a trade or business or for investment under Section 1031. A taxpayer utilizing the safe harbor in this revenue procedure also must satisfy all other requirements for a like-kind exchange under Section 1031 and the regulations thereunder.

This revenue procedure is effective for exchanges of dwelling units occurring on or after March 10, 2008. No inference is intended with respect to the federal income tax treatment of exchanges of dwelling units occurring prior to the effective date of the revenue procedure.

Terminology

Updated March 3, 2021

In the Exchange world, you will notice we have our own language when discussing IRC Section 1031, which may be confusing to those who are unfamiliar with exchange transactions. The following are some exchange terms and phrases that are often used with “plain-English” interpretations.

Qualified Intermediary (QI): The entity that facilitates the exchange for the Exchanger. Although the Treasury Regulations use the term “Qualified Intermediary,” some companies use the term “Facilitator”, “Accommodator” or “Middleman”. The Qualified Intermediary cannot be the taxpayer/Exchanger or a related party or an agent of the taxpayer.

Exchanger: The Property Owner, Client, Taxpayer seeking to take advantage by deferring capital gain tax by utilizing an IRC Section 1031 Exchange.

Tax Deferred: Does not mean tax free. Rather, through an IRC Section 1031 Tax Deferred Exchange, the taxpayer may delay payment of capital gain taxes on the relinquished property(ies).

Exchange: The relinquishing of one real property(ies) and replacing with another real property(ies). Under IRC section 1031 property held for productive use in a trade or business is exchanged for like-kind property held for productive use in a trade or business.

Like Kind: Both the property sold and the property purchased, constitute a real property interest. Examples of Like Kind are: commercial, residential rental, raw land, 30 year leases. Real property of the same nature or quality is like-kind. Generally, real property is like-kind to all other real property. Property located in the United States is not like kind to foreign real property.

Delayed Exchange: An exchange that takes place with time (a day up to 180 days) in between the initial date of closing relinquished real property and consummation of the replacement property(ies).

Simultaneous Exchange: An exchange wherein both the relinquish property(ies) and the replacement property(ties) are exchanged on the same day.

Direct Deeding: At the direction of the qualified intermediary, title is conveyed directly to the ultimate owners without the Qualified Intermediary being in the chain of title thus avoiding the imposition of additional transfer tax.

Relinquished Property: Phase 1, Downleg; Exchangers property to be sold in an IRC Section 1031 Tax Deferred Exchange by the Exchanger.

Replacement Property: Phase II, Upleg; Exchangers property being purchased in an IRC Section 1031 Tax Deferred Exchange by the Exchanger.

Constructive Receipt: Actual possession or control of exchange proceeds. Therefore, if the Exchanger has control over the exchange funds, that is considered “constructive receipt” and the exchange is voided. In order to avoid this, the Exchanger has an unrelated third party Alpine Tax Deferred Exchange Co., L.L.C. (Alpine 1031) hold the funds until the replacement property(ies) is purchased.

Terminology

Updated March 3, 2021

Identification Period: Within 45 days from the date of the close of escrow of the relinquished property, the possible replacement property must be identified in writing, typically to the Qualified Intermediary (Alpine Tax Deferred Exchange Co., L.L.C., (Alpine 1031).

180 Days: Total time allotted to acquire the replacement property. Must be one of the properties designated in the Identification Period.

Boot: Boot is any type of property received in an exchange that is not like kind; such as cash, Seller carry-back mortgage note, a boat, furniture, supplies, reduction in debt obligations or stock (Boot is not what you wear on your foot). In an IRC Section 1031 exchange, any funds generated from the relinquished property not used to purchase the replacement property will be called boot and the exchanger will pay taxes generated from relinquished property sale and the recognized gain for the amount received.

Capital Gains: Generally speaking, this is the difference between the sales price of the relinquished property – less selling expenses – and the adjusted basis.

Basis: The starting point for determining gain or loss in any transaction. In general, basis is the cost of the property.

Adjusted Basis: Simply stated, the adjusted basis is equal to the purchase price, plus capital improvements, less depreciation. Transactions involving exchanges, gifts, probates and trust distributions may impact the property's adjusted basis. The Exchanger's tax or legal advisor is the proper party to determine the adjusted basis.

Recognized Gain: Refers to the amount of gain that is subject to tax when property is disposed of – at a gain or profit – in a taxable transfer.

Realized Gain: Refers to gain that is not yet taxed. In a successful IRC Section 1031 Exchange, the gain is realized but not recognized and therefore not taxed.

Related Party: IRC Section 267(b) and 707 (b) (1) defines related party as any person or entity bearing a relationship to the Exchanger, such as: members of a family – brothers, sisters, spouse, ancestors and lineal descendants, a grantor or fiduciary of any trust; two corporations which are members of the same controlled group or individuals; corporations and partnerships with more than a 50% direct or in direct ownership of stock, capital or profits in these entities.

Qualified Exchange Accommodation Agreement ("QEAA"): A written agreement whereby the Exchange Accommodation Titleholder (EAT) agrees to purchase and hold title to the replacement property or relinquished property until the Exchanger/Taxpayer is able to sell the relinquished property.

Transfer Tax: A tax assessed by a city, county or state on the transfer of property that may be based on equity or value. The use of direct deeding in an exchange does not avoid the payment of normal transfer tax, but does avoid the payment of Additional Transfer Tax.

Safe Harbors: This term refers to the rules established by the 1991 Treasury Regulations for tax-deferred exchanges which provide that, if followed, the IRS will allow the exchange to qualify.