

EVERYTHING YOU ALWAYS WANTED TO KNOW ABOUT 1031 EXCHANGE

(BUT DIDN'T KNOW YOU SHOULD ASK 😊)

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DEFINITIONS

Taxpayer. The person or entity doing the exchange.

Relinquished Property. The property being exchanged.

Replacement Property. The property being acquired in the exchange.

Buyer. The buyer of the Relinquished Property.

Seller. The seller of the Replacement Property.

Accommodator. The company which holds Taxpayer's funds between sale of the Relinquished Property and purchase of the Replacement Property.

Exchange Value. The gross sales price of the Relinquished Property minus closing costs but including the amount which pays off the mortgage.

Realized Proceeds. The sales proceeds received by the Taxpayer including the amount used to pay off the mortgage.

Recognized Proceeds. The portion of the realized proceeds which is recognized as gain and taxed.

THE STARKER CASE AND EXCHANGE HISTORY

Section 1031 provides literally that two Taxpayers exchange properties with each other. Taxpayers wanted to have the flexibility to exchange by selling the Relinquished Property to a buyer, and buying the Replacement Property from a different third-party – a “deferred exchange.” This structure was approved in a case decided by the Federal Courts; the taxpayer was Starker, and now deferred exchanges are often called “Starker” exchanges.

The court made clear in Starker that the seller could not have access to the funds between transactions and this became one of the most important structuring issues in 1031 exchanges. As a result we began to structure exchanges using third parties to hold the funds between transactions and companies like T. G. Exchange were formed to act as accommodators and perform this service.

WHY EXCHANGE?

A Taxpayer who exchanges can use all of the net funds to buy Replacement Property because tax on the gain is deferred, as explained below. A Taxpayer can continue to exchange through his lifetime and at his death, his heirs will get a “stepped up” basis in the property: the heirs' tax basis in the property will be the fair market value of the property on the date of death of the Taxpayer enabling the heirs to sell the property without recognizing gain or paying taxes.

It is not always desirable to exchange, however. If the gain is small it isn't worthwhile to exchange because there are costs to exchange, and the basis of the Relinquished Property which is less than the purchase price is carried over thus reducing depreciable basis in the Replacement Property – a gain of less than \$25,000 - \$50,000 is usually the threshold

STRUCTURE OF AN EXCHANGE

An exchange is a sale of real property and the usual form of Purchase and Sale Agreement is used. It is not necessary to include special provisions but it is desirable to have a provision requiring that the Buyer cooperate in the exchange since he will have to sign exchange documents.

Before closing of the sale, the Taxpayer must enter into an exchange agreement and assign his contract rights to the accommodator so the Taxpayer should choose an accommodator when opening escrow, and inform the escrow officer that the sale is an exchange.

A Taxpayer can sell multiple relinquished properties and buy multiple replacement properties. If several Relinquished Properties are sold the time for identification and purchase of Replacement Property will begin at the time of each sale so it might be wise to structure an exchange of multiple Relinquished Properties so that each are exchanged separately and each has its own time deadlines for identification and acquisition of Replacement Property.

The Taxpayer will enter into a contract with the accommodator to hold the funds between transactions. When the Relinquished Property is sold, the funds are transferred to the accommodator which holds the funds and transfers to the escrow for purchase of the Replacement Property. The Taxpayer cannot receive, pledge, borrow or otherwise have the benefit of the funds while held by the Accommodator although the Accommodator can allow the Taxpayer to receive interest on the funds which can be paid after receipt of the Replacement Property.

The exchange funds can be used only to buy Replacement Property, pay closing costs or pay off a mortgage covering the Relinquished Property. Exchange funds cannot be used to pay off other debts or loans which are not secured by a mortgage of the Relinquished Property without recognizing gain.

FIRPTA AND HARPTA

Foreign sellers of real estate are required to pay 10% of the gross proceeds of sale as a withholding against Federal income taxes. If the seller is exchanging they are exempt from this deposit although a complex procedure must be following in filing with the Internal Revenue Service if the Replacement Property is not designated at the time of sale of the Relinquished Property.

Hawaii has a similar statute which requires that an out of state resident who sells real estate pay 5% of the gross proceeds of sale as a withholding against State income taxes. Out of state sellers who exchange are also exempt from the requirement.

MORTGAGES

A mortgage on the Relinquished Property can be paid off with exchange proceeds. The portion of the proceeds used to pay the mortgage are deemed realized however and are included in the exchange value, so the mortgage must either be replaced with a new mortgage or cash in purchasing of the Replacement Property.

If the Taxpayer borrowed funds to purchase the Relinquished Property, the loan cannot be repaid out of exchange funds unless the loan was secured by a mortgage on the Relinquished Property.

A Taxpayer cannot take back a note in partial payment of the purchase price of the Relinquished Property without recognizing gain because a note is treated as other property, not Replacement Property.

THE QUALIFIED USE TEST AND THE LIKE KIND TEST

Qualified Use

Both the Relinquished Property and the Replacement Property must be held either for use in a trade or business or for investment. "Held for investment" means that if the property is improved, it must be rented. That means that a Taxpayer who allows his children to live in property rent-free or a Taxpayer which holds the property but does not rent it is not holding it for investment. Vacant land generally cannot be rented and it will be deemed held for investment if it is held for increase in value.

Like Kind Test

The Replacement Property and Relinquished Property must be "like kind" which is very broadly interpreted and means that both must be held either for use in a trade or business or for investment but the properties do not have to be similar in service or related in use. A condominium can be exchanged for a single family dwelling or a shopping center for an office building. Any investment or business property can be exchanged for any other investment property or business property and meet the like kind test.

Leaseholds and Coops

A leasehold is like kind with a fee only if has more than 30 years of term remaining, including options to renew (whether or not renewed). A coop is not real estate in the conventional sense; rather it is stock in a corporation which owns the land upon which the project is located and a space lease of the apartment. A coop is deemed real estate in Hawaii however, so it can be exchanged, but if the apartment lease has less than 30 years of term, it can only be exchanged for a leasehold.

TAX CONSEQUENCES OF AN EXCHANGE

Basis

An exchange is not tax-free as it is often described; rather it is tax-deferred because the Taxpayer carries over its tax basis in the Relinquished Property to the Replacement Property. This means that the gain realized in the exchange transaction but not recognized will be recognized if the Taxpayer does not exchange when he sells the Replacement Property.

Basis in the Replacement Property is increased by any gain recognized on the sale of the Relinquished Property or by capital improvements installed after purchase and is also increased by the amount Taxpayer spends in excess of exchange value when acquiring the Replacement Property. It is important to understand the calculation of "exchange value" is in order to plan purchase of the Replacement Property and to have a fully-deferred exchange.

Exchange Value

Exchange value is the gross selling of the Relinquished Property minus deductible costs of sale but including the amount used to pay off the mortgage. Deductible costs of sale are items which would be deductible if the transfer were a sale and not an exchange such as

- Broker's commissions
- Escrow and title fees
- Attorneys' fees
- Accommodators' fees
- Fix-up expenses which would be deductible if sold

Loan fees and prorations are not deductible and do not reduce exchange value or increase the amount deemed to have spent on the Replacement Property. The Exchange value is not the bottom line on the closing statement and is not an amount some escrow companies call "exchange value credit" which is usually the amount of

cash transferred to the accommodator. Exchange value is also not the cash received or the profit or taxable gain. See Exhibit A for a calculation of exchange value.

Boot

Boot is gain realized in an exchange. Taxpayers can generate boot in five ways:

- Taking out cash from proceeds of sale
- Spending less than the exchange value on the Replacement Property
- Not replacing debt paid off on the Relinquished Property. The Regulations provide that paying off debt is not boot to the Taxpayer. But for the regulations the Taxpayer would be deemed to have used exchange proceeds for something other than acquisition of Replacement Property by paying the debt. Because the portion of proceeds used to pay debt is deemed realized, the Taxpayer must replace it either with new debt or cash in purchase of the Replacement Property in order to avoid recognizing it.
- Over-mortgaging the Replacement Property. For example: the Taxpayer sells Relinquished Property for \$500,000 with a \$100,000 mortgage and buys Replacement Property for \$500,000 but obtains a \$200,000 mortgage. The excess mortgage proceeds of \$100,000 is recognized as gain.
- Paying debts not secured by a mortgage on the Relinquished Property

If a Taxpayer takes out an equity loan immediately before selling the Relinquished Property or after immediately buying the Replacement Property is it boot? Congress considered a provision a number of years ago which would have made mortgages of Relinquished Property and Replacement Property close to the exchange boot but Congress did not pass it, and has not challenged it. There was a case where the Taxpayer took out a mortgage just before selling the Relinquished Property and the Tax Court held that there were good business reasons for it and allowed it.

If a Taxpayer wants to take out cash in an exchange, taking out an equity loan secured by the Replacement Property is the best course since mortgage proceeds are not taxed.

IDENTIFICATION OF REPLACEMENT PROPERTY

Within 45 days of closing of sale of the Relinquished Property the Taxpayer must identify Replacement Property. This is usually done by letter to the Accommodator. Within 180 days of closing of sale of Relinquished Property, or before the Taxpayer's next tax return is due, the Taxpayer must acquire the Replacement Property. These deadlines are absolute and cannot be changed or extended.

Replacement property must be “unambiguously identified” which means it must be identified by address or a tax map key number. A condominium project cannot be identified; the Taxpayer must identify particular unit numbers. It is not necessary for the Taxpayer to enter into a contract for purchase of the Replacement Property in order to identify it but the Taxpayer will be at risk that the properties identified cannot be acquired if he is unable to enter into a contract before expiration of the 45-day identification period.

The Regulations allow identifying multiple properties. A Taxpayer may identify as many as 3 alternate properties of any value. If more than 3 properties are identified, the value of the 3 cannot exceed 95% of the value of the Relinquished Property unless 95% of the properties identified are acquired. If any of the rules are not followed, the Taxpayer will be treated as not having identified any Replacement Property.

If three properties are identified, the Taxpayer can acquire one or more of the properties, and can acquire multiple replacement properties. Carryover basis is allocated *pro rata* to the purchase price of all properties acquired

REVERSE EXCHANGES

A reverse exchange is a transaction in which the Taxpayer has located Replacement Property he wishes to acquire, but has not sold his Relinquished Property. These transactions are popular in cold real estate markets because it is a buyer's market and it is more difficult to sell than it is to buy.

In a reverse exchange, the Taxpayer acquires the Replacement Property by “parking” it with an accommodator until the Relinquished Property can be sold. This is done by forming a single-member LLC of which the accommodator is the member which acquires the Replacement Property. The LLC and the Taxpayer enter into a contract providing for the LLC to hold the property until the Relinquished Property is sold and then to exchange it for the Replacement Property in a structured forward exchange. It is possible to do a partial forward/partial reverse exchange if a Taxpayer wants to sell several relinquished properties. Each time the Taxpayer sells a relinquished Property he purchases a *pro rata* portion of the Replacement Property from the LLC.

While the accommodator holds the Replacement Property, it must pay all expenses and treat the property as if owned by it, not by the Taxpayer and the Accommodator will require that the Taxpayer deposit amounts sufficient to cover insurance premiums, property taxes and any other expenses of ownership, but the Taxpayer is permitted to lease or manage the property. If the Taxpayer leases it, the lease could provide for the Taxpayer to pay taxes or buy insurance so management is simpler and is directly at the expense of the Taxpayer

In order for the LLC to acquire the Replacement Property in a reverse exchange, the Taxpayer must loan the funds necessary for purchase to the LLC because the Taxpayer will not have the proceeds of sale of the Relinquished Property. The LLC will give the Taxpayer a note secured by a mortgage of the Replacement Property to

document the loan. The Taxpayer can mortgage either the Relinquished Property or the Replacement Property or use a home equity line of credit to generate the funds. If the Taxpayer mortgages the Replacement Property the mortgage will be given by the LLC although the note can be signed by the Taxpayer.

When the Relinquished Property is sold, the Taxpayer and Accommodator enter into an exchange agreement, and the proceeds are used to pay off the note so the Taxpayer gets back the cash loaned for the purchase. The LLC membership interest can be conveyed to the Taxpayer rather than the property thus avoiding a second conveyance tax

RELATED PARTY EXCHANGES

Section 1031(f) provides that if a Taxpayer exchanges with a related party then the party who got the property in the exchange must hold it for 2 years or the exchange will be disallowed. Related parties are linear blood relatives and entities in which the Taxpayer owns an interest, but also include some complex relationships with trusts and entities.

The related party rules are complicated by Section 1031(f)(4) which provides that if a Taxpayer attempts to avoid the 2-year rule by structuring an exchange to avoid it, then the exchange is disallowed. The example of such a structure in the legislative history is if the seller sells the Replacement Property to the buyer of the Relinquished Property, and the buyer exchanges the Replacement Property for the Relinquished Property with the Taxpayer, then the Taxpayer will not be subject to the 2-year rule because she would not have exchanged with a related party. This is the only structure which could have this result yet the Tax Court ruled in a case which arose in Honolulu (and there have been several since as well as some IRS rulings) that a Taxpayer which used an accommodator to hold funds in an exchange was essentially trying to avoid the 2-year rule by “exchanging” with a third party which was not a related party.

The effect of this case is to eliminate the possibility of a Taxpayer acquiring Replacement Property from a related party even if the Taxpayer holds the Replacement Property for 2 years.

PARTNERSHIP EXCHANGES

Taxpayers cannot exchange partnership interests or acquire a partnership interest in a partnership which owns real estate except an interest in a single-member LLC. Single member LLCs are disregarded for tax purposes and treated as if the sole member owns the real estate.

Multi-member LLCs and partnerships are not disregarded for purposes of an exchange. Thus if a partnership owns real estate and wants to exchange it is the partnership which must exchange not the partners. The Partnership must acquire the Replacement Property. In one ruling the partnership distributed the proceeds of sale of

the Relinquished Properties to the partners, and each acquired their own Replacement Property. The exchange was disallowed.

What if some partners want to exchange and some do not? This can be done in three ways: (1) the partnership can dissolve before selling the Relinquished Property, distribute *pro rata* shares to the partners, and each can sell or exchange, (2) the partnership can acquire multiple Replacement Properties and then dissolve distributing the properties to the partners, or (3) the partnership can exchange, spend less than the exchange value, recognize the gain and specially allocate it to the partner who doesn't want to exchange, and distribute the cash to that partner in liquidation of his partnership interest.

CONCLUSION

An exchange is a very useful planning tool which allows maximizing returns on investment by allowing a Taxpayer to invest all proceeds of sale and defer capital gains taxes. If continued through a Taxpayer's lifetime it is a great estate planning tool because the Taxpayer's heirs will get the property with a basis stepped up to fair market value at the Taxpayer's death and then can sell without recognizing any gain.

EXHIBIT A

TENTATIVE EXCHANGE STATEMENT

T.G. EXCHANGE, INC.
AS QUALIFIED INTERMEDIARY FOR

ESCROW NO:
RPT DATE : 11/15/2010
CLOSE DT : 11/19/2010
PROPERTY :
TMK
ADDRESS

ESCROW AGENT:

TITLE GUARANTY ESCROW SERVICES, INC.
MAIN OFFICE
235 QUEEN ST
HONOLULU HI 96813

CONTRACT DATE : 8/23/2010

ATTN BARBARA PAULO

DESCRIPTION	DEBITS/CHARGES	CREDITS
Exchange Value		1,300,000.00
COMMISSION CREDIT		750.00
COMMISSION CREDIT		750.00
Mortgage payoff to:	404,951.00	
Loan no. 8100326431		
Principal balance	402,421.32	
Interest amount ***** to 11/19/10	2,469.68	
Other Fees	60.00	
Lender's payoff demand is available upon request.		
Mortgage payoff to:	212,196.77	
Principal balance	190,065.46	
Interest amount ***** to 11/19/10	22,131.31	
Lender's payoff demand is available upon request.		
Prorata items as of 11/19/2010		
R.P. taxes 11/19/10 to 01/01/11 @	8,737.66/6M	2,038.79
Maintenance fee 11/19/10 to 01/01/11 @	867.28/3M	404.73
Title search to TITLE GUARANTY OF HAWAII		1,820.00
Clean up-		4,000.00
Release Processing Fee to TITLE GUARANTY OF HAWAII INC		55.00
Attorney's Fee to MCCORRISTON MILLER MUKAI & MACKINNO		3,238.55
Escrow fee to TITLE GUARANTY ESCROW		1,874.34
Survey fee to HAWAII ENGINEERING GROUP		4,188.48
Commission to		32,500.00
Commission to		32,500.00
Record'g/filing fee		125.00
Conveyance tax		3,900.00
Exchange Value Credit		602,594.38
TOTAL	1,303,943.52	1,303,943.52

The undersigned read and understands the Controlled Business Arrangement Disclosure Statement from Title Guaranty Escrow Services, Inc.

Pro-rations to be adjusted to date of recording.

MORTGAGE PAYOFFS prorated to estimated date of receipt of collecting institution.

STATEMENT IS CONTINUED - THE 2ND PAGE ATTACHED HERETO IS A PART HEREOF. DATED: 11/15/2010

EXCHANGE VALUE

Gross Sales Price	\$1,300,000.00
Title Search	-\$1,820.00
Clean up	-\$4,000.00
Release Processing Fee	-\$55.00
Attorney's fee	-\$3,238.55
Escrow fee	-\$1,874.34
Survey	-\$4,188.48
Commission	-\$32,500.00
Commission	-\$232,500.00
Recording fee	-\$125.00
Conveyance tax	-\$3,900.00
Exchange Value	\$1,015,798.63