Steven J Roy Management

Cambyses Capital

1031 Exchange Considerations

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Preliminary Discussion:

- This document is a generic guide to the procedures and processes necessary to conduct a tax deferred exchange of real property under Internal Revenue Code Section 1031 and its state counterparts.
- We assume, in most of this discussion: An exchange of one or several Real Property Interests held with the intent to use them in a business or profession, for generating income, or holding them for investment purposes.
- We also assume that you are familiar with many (most) of the terms of trade in this discussion (e.g. Fair Market Value, Loan Acquisition Costs, Net Present Value, title, escrow…).
- The document is
    - Far from comprehensive. Each jurisdiction has its own rules; often they are different for different types of transactions in the same jurisdiction. Follow the advice of knowledgeable local counsel.
    - "A bit much" in some cases. By trying to achieve generality we sometimes introduce ambiguity, redundancy, or even "obscurity."
- The devil is in the details: some of the things we cavalierly describe as "procedure" or "filing" involve a great number of conceptual and procedural steps. By and large, if you don't know what we mean, ask!
- Apropos the preceding comment: ***This is not intended as a DIY guide.*** We strongly recommend that you delegate oversight for most of this process to someone who has done it before… Like Steven Roy Management or your counsel.
- This is an evolving document: Some sections are incomplete (consisting, in some cases, of notes about issues to be addressed later) or outdated (we try to avoid these, but sometimes they slip by). Review complete current requirements with counsel and your tax advisor before undertaking any transaction.

- **Legal counsels' opinion trumps ours. If legal counsel's advice or recommendations differ from ours, follow theirs (unless you know for certain that theirs is wrong… Then, seek other counsel).**

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Steven J. Roy: Steven is currently Chief Operations Officer of Steven J Roy Management, and Chief Operations and Compliance Officer for Cambyses Financial Advisors, LLC. For nearly forty-five years Steven has provided business development, management consulting, financial management, and tax services to aviation, entertainment, hospitality, technology, service companies, and real estate ventures. Through Steven Roy Management, Cambyses, and their predecessors, Steven has provided financial expertise to over 1,100 business ventures.

Steven has served as a director, officer, or trustee for over thirty-five public and privately held companies. He taught finance, taxation, and management to fellow professionals through UCLA Extension Services, has been a contributing editor for several professional journals, and has authored four book length publications (finance, tax, and economics). Steven was recognized as a Fellow of the National Tax Practice Institute in July 2003.

Steven supports not-for-profit organizations, civic and municipal activities, and churches-church administrators. He currently serves on the Board and as CFO for Advanced Heliophysics (A joint research project of JPL, UCLA, Cal-Tech, NASA, and NOAA), and Future XO. He is a Board Member of the Los Angeles Mounted Police Foundation and a management advisor to The New Festival, New York's LGBTQ Film Festival. Steven has served on the board of directors for the Tennessee Shakespeare Festival, World Heart Association and over 50 other arts, social, and humanitarian organizations. He was a member of the IRS National Technology Task Force and a financial affairs consultant to the United States Green Building Council and the Los Angeles Public Safety Employee Division. Internationally (through Crisis Recovery International) Steven has assisted development projects in Nepal (Women for Human Rights), Sri Lanka (Association of War Affected Women), India, Viet Nam, and the Philippines.

A graduate of UCLA (BS) and USC (MS), Steven also holds an MS in Taxation from California State University, Fullerton, and professional designations in real estate investment, financial planning, entertainment finance, accounting and equine operations. Steven is a licensed California Real Estate Broker (CalBRE License # 01706626) and broker of record for Steven J Roy Management. He is Managing Member and an Investment Advisor Representative (CRD #6499051) for Cambyses Financial Advisors LLC (CRD #230786). He is also an Enrolled Agent (Federal Registration #036074) and is enrolled to practice before the Internal Revenue Service's Compliance, Examination, Appeal, and Collections Divisions.

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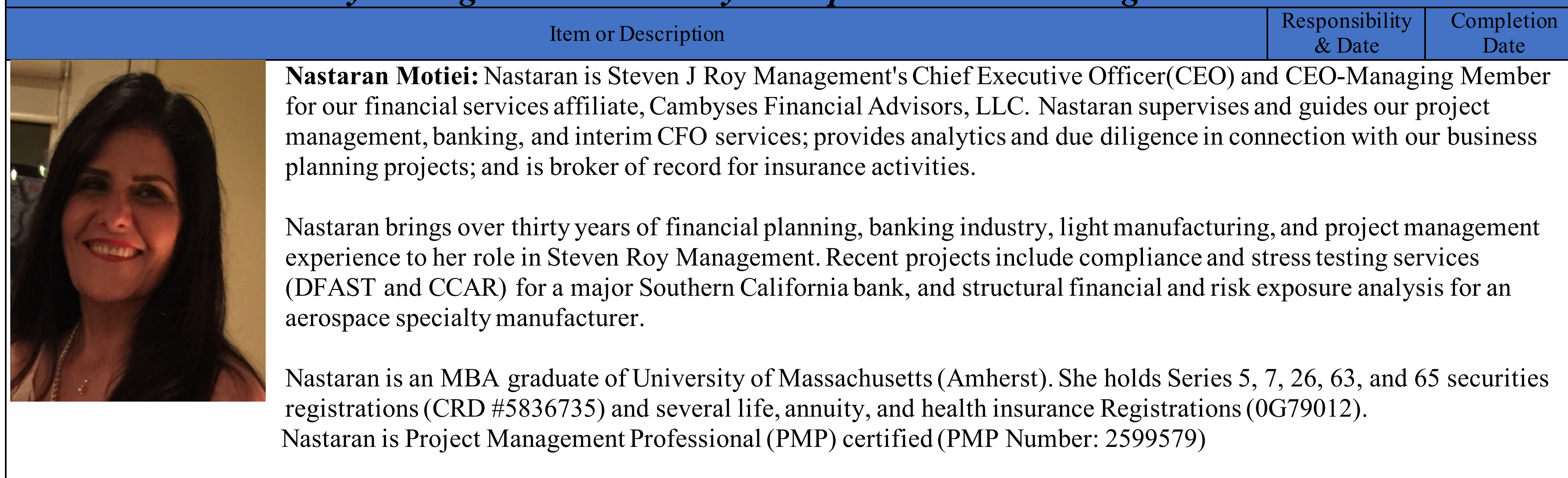

Nastaran Motiei: Nastaran is Steven J Roy Management's Chief Executive Officer(CEO) and CEO-Managing Member for our financial services affiliate, Cambyses Financial Advisors, LLC. Nastaran supervises and guides our project management, banking, and interim CFO services; provides analytics and due diligence in connection with our business planning projects; and is broker of record for insurance activities.

Nastaran brings over thirty years of financial planning, banking industry, light manufacturing, and project management experience to her role in Steven Roy Management. Recent projects include compliance and stress testing services (DFAST and CCAR) for a major Southern California bank, and structural financial and risk exposure analysis for an aerospace specialty manufacturer.

Nastaran is an MBA graduate of University of Massachusetts (Amherst). She holds Series 5, 7, 26, 63, and 65 securities registrations (CRD #5836735) and several life, annuity, and health insurance Registrations (0G79012).
Nastaran is Project Management Professional (PMP) certified (PMP Number: 2599579)

Preliminaries: What are we Talking About?

General Rule for Sales and Exchange Transactions

The sale or exchange of property results in recognition of gain or loss under the Internal Revenue Code.

Realized gain is reported (recognized) as ordinary income, recapture income, capital gain, or a hybrid of several tax classifications and is taxed (recognized) in the year the gain or loss is realized through a completed sale.

The general rule applies to gains from transactions in personal-use, business or investment property and to gains from property held for production of income. Though the exact recognition rules differ, the general rule applies to sales of Realty, Personalty, Tangible, or Intangible property.

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Tax Deferred Exchange Exception: IRC §1031 Internal Revenue Code (IRC) §1031 is an exception to the general rule. Under IRC §1031 gain recognition and taxation are postponed. Gains are not taxed until the property acquired in the §1031 transaction is sold in a subsequent transaction that does not qualify for tax deferral. IRC §1031 does not apply to transactions in which a loss is realized. Losses must be recognized in the tax year they are incurred. IRC §1031 is one of several provisions that postpone or reduce tax on realized gains (c.f. IRC §1231). It may not be the most advantageous treatment available for a specific transaction. Gain recognition may sometimes be preferable to deferral under IRC §1031.		
Advantageous tax treatment is accorded only if the properties and the sale process meet rigorous tests. The tests are triggered when a property (the relinquished property) is sold in a carefully structured transaction in which a "replacement property" (the acquired property) is purchased. Because, in its simplest form, this transaction resembles a trade of one property for another, it is often called a §1031 Exchange. IRC §1031 is, however, much more flexible than that simplification implies. (See "*Common Exchange Forms*," below)		
IRC §1031 Requirements The §1031exchange transaction and the properties involved in it must meet several criteria: 1. *The holding and intent test:* The relinquished and acquired properties must be held for business purposes, or for production of income, or for investment (Any of the three). (See "*Holding and Intent,"* below); 2. *The like-kind test:* The relinquished and acquired properties must be similar in nature, character, class and use. (This is not as straightforward as it sounds.) (See: "*Like-Kind Property*," and "*Boot*," below);		

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3. *The identification, closure, and control tests:* The sale and purchase transactions must meet several stringent time deadlines and the proceeds from the sale transaction must not be subject to the seller's control at any time during the process. (See "*Identification and Closure*" and "*Control of Funds-Qualified Intermediary,*" below); 4. *The boot rule:* In multi-asset exchanges, some of the exchanged assets may not qualify for deferral. If some exchanged assets do not qualify as like kind, that portion of the transaction will be treated as taxable. Example: J exchanges an apartment building for another apartment building and a pair of hand tooled cowboy boots. The fair market value of the cowboy boots is … taxable Boot in the transaction. (See *"Boot"* and "*Reinvestment Strategy – Implicit Requirements,*" below) 5. *Excluded properties:* Some assets may not be exchanged in an IRC §1031exchange. (The most problematic of these exclusions – securities and partnership interests are frequently part of real estate exchanges.) {See "*What Can (and Can't) Be Exchanged,*" below}		
Pre-Transaction Considerations: Consult with Counsel and Professionals		
IRC §1031 Exchanges Require Teamwork IRC §1031 Exchanges are not do-it-yourself projects. You need a transaction team, and you need to brief them beforehand. Expect your team to be bigger for IRC §1031 exchange transactions than it is for a conventional sale or purchase. Specifically; the §1031 team includes: • One or more attorneys; • At least one accountant/tax professional; • Two or more real estate agents/brokers; • Two or more appraisers; • Two or more escrow agents; • At least one qualified intermediary (transfer agent); • Two or more lenders' representatives;		

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Consult with counsel, accounting representatives and bankers before initiating the transaction. Identify the assets included in the transaction and identify their characteristics.		
Relinquished (sold) Assets What asset(s) will be relinquished (sold)? • Determine whether assets included in the sale comprise one or several properties. • Determine the adjusted basis and fair market value of each relinquished property. • Identify and quantify the components of the relinquished assets' adjusted basis (e.g. Personalty (tangible or intangible), land, structures, improvements, depreciation, amortization). • Identify and quantify encumbrances on any relinquished assets. (Consider whether the encumbrance or the terms of collateral agreements restrict your ability to relinquish the property.) • Determine how title to the relinquished property is held. {Title determines who realizes and recognizes gains in the transaction. Last minute title changes are suspect, at least in the IRS/FTBs' view. (See "*Drop and Swap,*" below)}		
Acquired (purchased) Assets What will be acquired (purchased)? • Are (will) the relinquished and acquired assets be held for use in a business or profession or for the production of income? For how long? (See *"Holding and Intent,"* below) • Are both the relinquished and acquired assets eligible for deferred gain recognition under IRC §1031? (See *"What Can (and Can't) be Exchanged,"* below) • Are the relinquished and acquired assets "like-kind" within the meaning of the statute? (See *"Like Kind Property"* and *"Boot,"* below)		

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Financing the Transaction • How will you pay for the acquired property? (Bring the bankers in early in the process. Loan funding is usually the most problematic part of the closure process.) • How will title be held? (Think about how title on the acquired property affects the next acquisition or disposition. Resolve the major details of any shareholder, operating, or partnership agreement before you face intractable deadlines.)		
Practicalities: For each potential relinquished property: • Estimate fair market value, determine adjusted basis, and estimate each of the components of their adjusted basis. (N.B. Adjusted Basis may be different for federal and state purposes.) • Estimate the tax impact (if any) of recapture items. Create a pro-forma replacement property: • Estimate the maximum purchase price and net operating income needed to obtain and sustain the property within (typical) lender's limiting ratios. • Estimate the minimum replacement price and leverage required to qualify for deferral under IRC §1031 and its state counterpart. • Estimate the property's tax basis and the depreciable/amortizable portion of that basis. • Estimate the tax impact (if any) of the above items.		

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IRC §1031 After the Tax Cuts and Jobs Act (TCJA) – Limits and Interactions		
Scope Limitation TCJA reduces IRC §1031's scope. Most significantly, TCJA eliminates IRC §1031 treatment for "like kind exchanges" that involve property other than real property interests. Whereas under pre-TCJA rules, an exchange of (e.g.) one printing press for another could qualify for IRC §1031 deferral, it cannot qualify in the post TCJA regime. TCJA's scope limitation would be merely a minor tax setback, if every state conformed to Federal rules. Unfortunately, several states (California is one of them, surprise-surprise) did not conform to the new Federal restriction. In those states there will be transitory, but significant and long lasting, differences between basis (adjusted basis), depreciation and gain or loss, reported for Federal purposes and state purposes. Those differences will persist for the economic lifetime of the affected property. California business owners have become accustomed to oddly inexplicable differences between California and Federal asset management requirements. For them, TCJA merely introduces another quirk. For anyone new to California – Welcome to the Land of Excessive Recordkeeping.		
Allocation to Personalty and Intangibles TCJA's scope limitation necessitates allocation between IRC §1031qualified assets and boot in nearly every future transaction. Buildings are seldom exchanged without at least some of their contents changing hands as well. Unless the exchange is bifurcated into an IRC §1031qualified exchange and a non-qualified sale of "building accoutrement" (Equipment, furnishings, etc. that are not appurtenant to the land or structure) – the transaction arithmetic may become unduly complex. This places a premium on inspection and identification of building components – so you know what you are buying (or trading).		

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Interaction – Post TCJA Depreciation, and Bonus Depreciation TCJA creates new, generally more liberal, options to accelerate depreciation of both properties acquired in IRC §1031 exchanges and boot. These liberalized provisions, under IRC §§168 & 179, may benefit from Segmentation Studies to reap the full benefit of the provisions in the wake of an IRC §1031 transaction.		
Interaction -- New IRC §199A TCJA created a new section of the tax code, IRC §199A. Section 199A provides a 20% deduction for sole proprietors, pass-through entities such as limited liability companies, partnerships and S-Corporations. This 20% deduction provides tax rate relief and parity to pass-through entities vs. C-Corporations. (C-Corporations permanently benefit from a reduced corporate tax rate of 21% - considerably below the rate for pass through entity owners.) The Service has since released two, very different, sets of IRC §199A regulations. The first set of proposed regulations left the industry in a quandary: Did the Service really intend the choice between IRC §1031 and IRC §199A to be an "either or proposition?" As it turned out, NO. The preliminary IRC §199A regulations were simply another example of the "Draft (legislation) in haste, repent at leisure, it's someone else's problem" attitude that pervaded TCJA's deliberation and its subsequent adoption process. In early 2019, Treasury released additional guidance (including Revenue Rule 2019-07) that created a safe harbor in which IRC §1031 and IRC §199A could co-exist. The revised regulations introduced a new tax concept, the "rental real estate enterprise" permitting real estate rentals to be treated as a trade or business for purposes of §199A. The Final Regulations clarified the calculation of the unadjusted basis immediately after acquisition ("UBIA") of replacement property acquired by a taxpayer in a §1031 exchange. As corrected, the Regulations permit deferral via a 1031 exchange (advantageous at the time of disposition) and further tax benefits (through IRC §199A) while you own investment property.		

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The only bad news here: The interaction is complex. Most taxpayers will require professional help to realize its full benefit.		
What Can (and Can't) be Exchanged		
Permissible Exchanges Short answer: Unless it is specifically excluded (see below) any real property interest you own that is either 1) used in a business or profession; or 2) held for production of income; or 3) held for investment; is potential fodder for an IRC §1031 Exchange. After the Tax Cuts and Jobs Act (TCJA) Business machinery or equipment and intangible assets no longer qualify for gain deferral under §1031. (There is an exception-safe harbor provision for sports contracts.) Note, however, that this type of transaction was rare, fraught with risk, and arithmetically complex even before TCJA. Before TCJA exchanges of business, rental, or investment real property interests for other business, rental, or investment real property interests were the most common application of the exchange rule. After TCJA, they are the only exchanges that qualify. The high value, potentially high gains and tax exposures, and detailed compliance requirements make tax deferred realty exchanges especially attractive – to both taxpayers and Revenue Agents.		
Ineligible Exchange Property and Interests Some properties and transactions are not eligible (by statute) for IRC §1031 exchange. • Property used primarily for personal use does not qualify for like-kind exchange treatment. E.g. A primary residence does not satisfy the holding and intent tests. (Gain on a personal residence may be partially excluded under IRC §121. See other Steven Roy Management - Cambyses Capital publications for additional information.)		

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• Other types of property expressly excluded from IRC §1031 (Via IRC §1031(a)(2)) a) stock in trade or other property held primarily for sale, b) stocks, bonds, or notes, c) other securities or evidences of indebtedness or interest, d) interests in a partnership (including Limited Liability Companies), e) certificates of trust or beneficial interests, or f) choses in action. The stock in trade exclusion includes inventory held for sale by dealers in real property. Partnership interests cannot be traded because (under most state rules) ownership of the partnership interest does not imply ownership in the underlying real property. An "exception to the exclusion" of partnership interests (which include LLC interests as well) is sometimes invoked by real estate partnerships: "For purposes of this section, an interest in a partnership which has in effect a valid election under section 761(a) to be excluded from the application of all of subchapter K shall be treated as an interest in each of the assets of such partnership and not as an interest in a partnership." Translation: Tenancy in Common interests in real property may be exchanged in an IRC §1031 exchange under some conditions. (See "*Drop and Swap,*" below) The exception has spawned a minor cottage industry in "Drop and Swap" transactions. {"Dissolve" the partnership, "distribute" TIC interests (Drop). Exchange the TIC interest for another property interest (Swap).} These transactions require preparation, caution, and (ideally) a good deal of lead time. (See "*Drop and Swap,*" below) Note that the same result as Drop and Swap can be achieved by holding the real property interest in a "Delaware Statutory Trust" (DST) or TIC from the outset rather than in partnership or LLC solution. (DST and TIC interests represent direct interests in the underlying property – therefore may be exchanged directly and without exposing owners to the tender mercy of drop-and-swap purveyors.)		

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Common Exchange Forms:		
Common Transaction Scenarios IRC §1031 exchanges take several common forms: • Simultaneous Exchanges • Forward Starker, Delayed Exchanges • Reverse Starker, Delayed Exchanges • Build-To-Suit or Rehab Exchanges • Partial §1031 Exchanges • Drop and Swap Exchanges		
Simultaneous Exchanges: The relinquished property transaction and the like-kind replacement property transaction close (settle) at the same time. • The simplest variation: Two people, two properties. • Not as common as one might think: It requires that I have a property you want and vice-versa.		
"Forward Starker," Delayed Exchanges: The relinquished property transaction closes (triggering several time constraints). Proceeds from the relinquished property are "parked" with a Qualified Intermediary. Replacement property is identified and closed within strict time limits. • Generally, four or more participants (You, the intermediary, your buyer, and the replacement property seller); • Probably the most common IRC §1031 exchange;		

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• A Qualified Intermediary is REQUIRED (See "*Control of Funds – Qualified Intermediary,*" below); • Strict time limits apply. (Professional Note: Starker transactions are named for the plaintiff who successfully defended this model. Cf. *Starker v. United States*, 602 F.2d 1341; 79-2 USTC 9541; and 44 A.F.T.R.2d 79-5525 (9th Cir. 1979)		
"Reverse Starker," Delayed Exchanges: The replacement property transaction closes (triggering several time constraints). Title to the replacement property is "parked" with a Qualified Intermediary. The relinquished property is sold within strict time limits (proceeds are parked with the Qualified Intermediary). The Qualified intermediary distributes the replacement property and/or the proceeds. • Generally, four or more participants (You, the intermediary, your buyer, and the replacement property seller); • Less common than "Starker Exchanges" (This transaction requires that you have liquidity and be willing to take deadline related risks); • A Qualified Intermediary is REQUIRED (See "*Control of Funds – Qualified Intermediary,*" below); • The Qualified Intermediary will hold title to the replacement property through a Qualified Exchange Accommodation Titleholder (Q-EAT). • Strict time limits apply.		
Build to Suit and Rehab Exchanges: The relinquished property transaction closes (triggering several time constraints). Proceeds from the relinquished property are "parked" with a Qualified Intermediary. Replacement property is identified, constructed or improved, and closed within strict time limits. • Extremely rare and risky: Construction, installation, or permit delays can be devastating. • A Qualified Intermediary is REQUIRED, the QI may need to possess special skills (See "*Control of Funds – Qualified Intermediary,*" below);		

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• The Qualified Intermediary will hold title to the replacement property and the funds needed to build or rehab it through a Qualified Exchange Accommodation Titleholder (Q-EAT). • Strict time limits apply.		
Partial IRC §1031 Exchanges: The purchaser acquires "Boot" (assets that do not meet the requirements for an IRC §1031 Exchange) to equalize the fair market value in the relinquishment/sale transaction. The transaction is otherwise similar to one of the other forms. • Example: You exchange an office building for farmland (that has a bunkhouse and a landing strip) and a private plane. You operate the farm and commute to the city in the plane. (The plane is boot.) • Gain is recognized and taxed up to the fair market value of the boot (plane) received. • You must allocate fair market values between IRC §1031 Exchange property and boot… You may need more than one appraiser. (In our example, both a real estate and an aircraft appraiser may be required.)		
"Drop and Swap" Exchanges: Property held by an entity (usually a partnership or LLC) is distributed {Usually as a Tenancy in Common (TIC) interest in the property.} The TIC interest is exchanged (is the relinquished property) in a purportedly IRC §1031 compliant exchange. • These transactions are becoming increasingly common as commercial/residential investment property held by partnerships or LLCs appreciates. • Done in haste: An IRS/FTB audit minefield. IRS/FTB audit strategy focuses on three major issues (See *"Drop and Swap,"* below). • Done in leisure: Not much more audit risk than any other IRC §1031 Exchange. • Drop and Swap's near cousin, "Swap and Drop," is subject to many of the same risks and qualifications. • Note that both IRS and FTB now require that participants in Drop and Swap transactions disclose their participation on their return for the transaction year.		

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Do not try this at home: Use a tax professional and legal counsel to bird-dog the transaction. (See “*Drop and Swap,*” below)		
Holding (Intent) Requirement		
Holding Holding: IRC §1031 requires that you hold both the relinquished property and the acquired property “for productive use in a business or for investment.” • Neither code nor regulations illuminate how you go about documenting compliance with this requirement. • Code and regulations are similarly silent about how long you must “hold” the properties. Several generalizations are defensible: • The longer the relinquished and acquired properties are held, the more likely they satisfy the holding requirement. • Actual or intended use of the property in a business or for production of income generally satisfies the holding and intent requirement. In most cases, it is clear if the holding requirement has been met. Example: A building or an interest in one, acquired for, and used as a rental property for a protracted period satisfies the holding and intent test. Counter Example: A building or interest in a building, acquired for use in a subsequent, pre-negotiated, tax deferred transaction may not satisfy the holding and intent test.		

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Counter Example: A building or interest acquired in a transaction motivated primarily by tax-avoidance cannot satisfy the holding and intent test. (This is one of the grounds on which IRS/FTB attacks Drop and Swap transactions. (See *"Drop and Swap,"* below)		
Intent Satisfying the holding requirement often hinges on "intent." Consistent, long-term, behavior is the most reliable indicator of intent. Example: A building that will be relinquished has been held in the business, operated as appropriate, and depreciated consistently. The replacement building (which serves a similar purpose) will be treated similarly for tax and accounting purposes. Both properties satisfy the holding and intent requirement. Pro- and Counter Example (Same transaction, different results for different participants): A building owned by an LLC has been depreciated and operated by the LLC and reported on the LLC's partnership return. "One or several members" want out of the investment. The LLC dissolves and distributes the property interests as TICs. "One or several" members immediately exchange their TICs for other property interests. Their TICs may not satisfy the holding requirement (They were acquired primarily to achieve a tax objective that liquidating or exchanging the partnership interest could not achieve). The remaining TIC owners hire a management company, retain their interests for a year or so and report income and expenses of the property accordingly. Their interests will probably satisfy the holding test in an eventual exchange (since they were acquired for investment or for generation of income). The longer they wait to dispose of the TICs, the stronger their argument becomes.		
Practicalities: As soon as the property to be relinquished is identified, counsel or tax advisors should determine whether the property is "held for business or investment" within the meaning of the statute. This task should not be entrusted to		

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any of the realtors involved in the process unless they have specialized tax training and are sufficiently independent to render an objective opinion. (The realtors' commissions generate a strong conflict of interest.) (Professional Note: Cf. Re: Holding and Intent, Rev. Rul. 75-291, 1975-2 C.B. 332; Rev. Rul. 77-297, 1977-2 C.B. 304; Rev. Rul. 84-121, 1984-2 C.B. 168; Rev. Rul. 75-292, 1975-2 C.B. 333; Rev. Rul. 77-337, 1977-2 C.B. 305; LTR 8310016 (Dec. 1, 1982); LTR 8429039 (Apr. 17, 1984) for IRS thinking on this point.) (IRS guidance on partnership vs. TIC for Drop and Swap transactions is included in IRC §7701, Reg. §1.761-2 and IRS Revenue Procedure 2002-22, 2002-14 IRB 733)		
Like-Kind Property (and Qualifying Use)		
Like Kind Property The relinquished property and the acquired property must be "like-kind." The IRS defines like-kind to mean properties that are similar in nature, character, and class. This distinction has lost much of its potency in the post TCJA environment – Real property interests may qualify for tax free exchange – Everything else is Boot (unless you happen to own a sports franchise). Still, the former distinctions that look at how the property is used in production or service processes remain instructive – particularly in California: In two classic examples: • Bulls are not Like-Kind with Cows. Bulls are used to produce baby cattle (or haploid cattle cells). Cows are used to produce milk and meat. Note: Same sex livestock exchanges qualify. Different sex livestock exchanges do not {c.f. IRC §1031(e)}. The livestock themselves seem unimpressed by this distinction.} • Cars are not Like-Kind with Trucks. Cars haul people and their possessions from place to place. Trucks haul "stuff" from place to place.		

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By extension:
 	
• Realty (of any kind) is not like-kind with Personalty (of any kind, tangible or intangible), including Personalty that is incidentally included in the transaction (e.g. furnishings, office equipment, supplies);
• Most Realty (if held for business, production of income or investment) is like kind with other Realty held for business, production of income or investment;
    ○ Exception 1: Real property used for Personal Use is not Like-Kind with Realty held for business, production of income or investment
    ○ Exception 2: U.S. Realty is not Like-Kind with Non-U.S. Realty {c.f. IRC §1031(h)};
    ○ Exception 3: Improvements conveyed without land are not like-kind to land;		

Boot		
Definition The term "boot" is not defined in either the Internal Revenue Code or the Regulations; Boot is a term of trade rather than a hard law concept. Conceptually, Boot is the money or the fair market value of "other property" you receive in an exchange. Money includes all cash equivalents and any of your liabilities that the other party assumes. "Other property" includes any non-like-kind or "non-qualified property." Seller financing is considered boot.		
How Boot Happens • *Cash taken from the exchange (Paid out at closing):* The difference between cash received from the sale of the relinquished property and cash paid to acquire the replacement property is called Net Cash Received and treated as boot. Net Cash Received results if you "Trade down" in the exchange (i.e. the sale price of replacement property is less than that of the relinquished properties.) • *Non-like-kind property received from the exchange:* If, in addition to like kind property, non-like-kind property is received in the exchange, the Fair Market Value of the non-like-kind property is boot.		

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• *Debt reduction boot:* Debt reduction boot occurs if your debt on the replacement property is less than the debt secured by the relinquished property. Debt reduction boot occurs if you "Trade down" in the exchange. If you deposit cash into escrow from sources other than the transaction the cash offsets Debt reduction boot. • *Sale proceeds used to pay non-qualified expenses:* Example; service costs paid at closing which are not closing expenses. If you use proceeds from the sale to service non-transaction costs at closing, the payments are treated as boot. To avoid this, bring cash to the closing of the sale to pay the Non-transaction costs: e.g. Loan acquisition costs, rent proration, utility escrow charges, tenant damage deposits transferred to the buyer (See a more comprehensive list below). • *Excess borrowing:* Borrowing more money than is necessary to close on replacement property also creates boot. The loan is first to be applied to the purchase. All unused exchange funds are returned to the Qualified Intermediary, either to acquire more replacement property or to be distributed at the end of escrow. If distributed, the distribution is boot. The IRS maintains that loan acquisition costs (origination fees and other fees related to acquiring the loan) are paid with Exchange Funds unless equivalent personal funds are deposited to the escrow. Taxpayers argue that loan acquisition costs are paid out of the proceeds of the loan. Note: The Service's position on this mirrors that of most lenders. Consequently, loan origination charges are sometimes classified as boot – depending on how alert and sophisticated the examining agent is.		
Consequences of boot: If you receive boot (in any form) in the transaction, tax will be payable on the lesser of; • Total boot received, or • The realized (but unrecognized) gain from the transaction. Adjusted Basis in the replacement property is increased by the amount of boot/gain recognized in the transaction.		

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Payments from escrow (Normal settlement costs): The following costs are considered transaction costs or boot, respectively:		

YES (Exchange Expense, Not Boot)	NO (Non-Exchange Expense, Boot)	MAYBE
Sales Commission	Rent Proration	Appraisal Fees
Legal Fees	Utilities	Inspection/Testing Fees
Finders Fees	Points	
Escrow Fees	Mortgage Insurance	
Inspection/Testing Fees	Property Liability Insurance	
Transfer Taxes	Application Fees	
Title Insurance Fees	Lender's Title Insurance	
Recording Fees	Assumption Fees	
Property Taxes	Homeowners or Association Dues	
Exchange Fees	Repairs/Termite Work	
Messenger Fees	Security Deposits	
Document Fees	Replacement Property Loan Acquisition Fees	
Statement Fees		
Tax Service		
Processing Fees		
Notary Fees		

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Item or Description	Responsibility & Date	Completion Date
Identification and Closure		
Identification and closure: Time deadlines IRC §1031's stringent time deadlines cannot be extended except by a Federally declared emergency or disaster. *Identification:* Replacement property must be identified within 45 days of the close of the relinquished property sale. The identification must be specific and must be communicated to a neutral or adverse party in the transaction. Your attorney, real estate agent, accountant or similar person acting as your agent is not a neutral or adverse party. Notice is usually given to the Qualified Intermediary or the replacement property's seller. If you don't identify replacement properties or you don't notify the neutral or adverse party within the time limit, the 1031 Exchange fails. The sequestered assets held by the Qualified Intermediary transfer back to you. You are then responsible for all taxes resulting from the sale, computed under the general gain-loss rules. *Closure:* The replacement property transaction must close (possession or title must transfer) within 180 days of the close of sale of the relinquished property. The replacement property must be substantially identical to the property identified in the communication with the neutral or adverse party. The identification and closure periods run concurrently. The longer identification takes the less time is available for closing. If Identification is complete on the 45th day, closing must be completed within 135 days after that. *Timelines and personnel for Reverse Starker transactions:* In Reverse Starker transactions, the replacement property is purchased before the relinquished property is sold. The Qualified Intermediary forms a Qualified Exchange Accommodation Titleholder (Q-EAT) to hold title to the acquired property during the transaction. (The mechanics of this assignment can be complex.) Once the Q-EAT closes on (or takes possession of) the replacement property i) the relinquished property must be identified within 45 days, and ii) sale of the relinquished property must conclude within 180 days. Market conditions (e.g. average time on market) can make this timeline harrowing unless the sale of the relinquished property and the buyer's financing are assured.		

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Notice requirements (content and delivery to a neutral or adverse party) are similar for forward and reverse Starker transactions, except that the required notice refers to the relinquished property in a Reverse Starker transaction, and to the acquired property in Forward Starker transactions.		
Restrictions on Identification: To prevent abuse of the Identification process, the Code imposes restrictions on the number or the fair market value of properties which can be identified as potential Replacement Properties. To satisfy the restrictions, you must satisfy at least one of these rules: • *The Three-Property Rule:* Identify up to three properties regardless of their market values. The rule is satisfied if you close on one or more of the properties and satisfy the "step-up in value" requirement. • *The 200% Rule:* Identify any number of properties whose aggregate fair market value does not exceed 200% of the aggregate Fair Market Value (FMV) of the relinquished properties as of the initial transfer date. The rule is satisfied if you close on one or more of the identified properties and satisfy the "step-up in value" requirement. • *The 95% Rule:* Identify any number and any value of replacement properties. The rule is satisfied if you close (purchase) on properties that constitute at least 95% of the aggregate FMV of the identified properties. You don't get an identification mulligan if the identified property is destroyed in a casualty 46 to 180 days into the exchange. Therefore, it is usually advisable to identify several replacement properties (We generally recommend you identify three properties) and close on a sufficient number to satisfy one or more of the identification tests and the "step-up-in-value" requirement. (See the note under "Practicalities," below re: revoking identifications within the time limit.)		
Content of the Identification Notice • The identification must be in writing, signed by you and delivered to a neutral or adverse party involved in the exchange (e.g. the seller of the replacement property or the qualified intermediary).		

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• Replacement property must be clearly identified/identifiable from a legal description, street address or distinguishable name. (It is not clear whether an assessor I.D. number is sufficient.) • You must close on a sufficient number of (or value of) properties to satisfy one or more of the identification tests noted immediately above.		
Practicalities: *Within 45 days after the relinquished property sale closes:* Identify replacement properties using a description and procedures consistent with the guidelines above. If you identify more than three properties, you may later revoke designations to reduce the number of non-revoked properties to three or less. Revoke the designations by a written signed letter sent to the neutral or adverse party to whom the identification statement was sent, not later than 45 days after closing the Relinquished Property sale. If you do not revoke the identifications in a timely manner, the 200% or 95% rules automatically apply. *Third party acknowledgements in the relinquished property sale and the acquired property purchase contracts:* Your sale and purchase agreements for each of the properties involved in the exchange should include clauses that • Inform the buyer (seller) of your intention to pursue an IRC §1031 exchange, • Require their acknowledgement of your intention and their cooperation, • Hint strongly that you will pursue available remedies if they don't cooperate. *Insert language in the replacement property purchase agreement that allows the agreement to be assigned to a Qualified Intermediary.* California Association of Realtors and AIR's standard commercial/industrial purchase and sale agreements include a check the box election for each of the above provisions.		

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For the relinquished property and each potential replacement property: Determine whether the property is Like-kind to each of the relinquished properties. For any non-like property, estimate the realized and recognized gain and simulate its effect on tax for all possible principals. {Professional Note: Some sources incorrectly state the closure limit as "six months." The code provision requires closure "no later than 180 days after the sale of the exchanged property or the due date (with extensions) of the income tax return for the tax year in which the relinquished property was sold, whichever is earlier." To limit confusion or accidental violation of this compound deadline, Steven Roy Management\Cambyses Capital extends all returns for clients who are currently involved in IRC §1031 exchanges.}		
Reinvestment Strategy – Implicit and Explicit Requirements		
Buy-Up and Borrow Up Strategies IRC §1031 exchange arithmetic implies that (in a fully deferred tax transaction) all of the equity in the relinquished property is used to acquire a property that is "more valuable" than the relinquished property. Further, if the acquired property is not subject (in your hands) to mortgage obligations at least as large as those on the relinquished property (or you contribute additional cash to the deal) the deal may incur tax (Debt relief is both consideration and boot). This logic imposes three IRC §1031 exchange reinvestment requirements that are not explicitly stated in the Code. *Trade Up or Equal:* The acquired property's value must equal or exceed the net sales price and total purchase price of the relinquished property. (This condition has nothing to do with your equity in the property.) *Incur Equal or Greater Debt (Borrow Up):* Unless you inject additional funds from other sources, a properly structured IRC §1031 exchange requires that you incur new debt (equal to the difference between total purchase price of the replacement property and the net proceeds from the relinquished property); an amount that exceeds the debt on the relinquished property. Eventually, you must service this new (higher) debt amount. Long before closing, explore lender financing for the replacement process; ideally obtain pre-approval for the anticipated debt amount. Last minute lender refusals to fund		

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are not unheard of and are no fun at all. (Pro-forma a hypothetical transaction to determine the limits of replacement property's LTV and DCR for a range of interest rates. Use that pro-forma to restrain your enthusiasm for buying bigger, possibly unaffordable, replacement properties.) *Reinvest 100% of Net Proceeds:* Any funds or property distributed to you at close of the transaction is treated as boot. You will be taxed on its fair market value to the extent it does not exceed your realized gain in the transaction.		
Practicalities: If the relinquished property is subject to encumbrances, determine their effect on total boot in the transaction. Begin negotiation and approval for needed financing early in the transaction. Pro-forma the effect of additional financing on the loan to value and coverage ratios for the acquired property: Are they within your lenders' limits? If boot will be distributed, estimate the recognized gain, apportion the gain to the properties (and their components) involved in the transaction. Simulate the transaction's effect on taxable income and tax for the known principals.		
Control of Funds – Qualified Intermediary, Constructive Receipt (And a Short Sermonette)		
Control or Receipt of Funds If, at any point before closure and during the exchange, you take possession of any funds or boot received for the relinquished property (or title to the acquired property in a Reverse Starker transaction), the entire transaction is disqualified from IRC §1031. If the transaction is disqualified, the entire gain is taxable in the year the relinquishment transaction closes.		
Qualified Intermediary Most IRC §1031 transactions are conducted through a "Qualified Intermediary" (QI, sometimes called a 1031 Accommodator). (We know of no case where a QI is not required. We say "Most" because there may be exceptions		

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we haven't heard about.) A QI is an independent party that facilitates a tax-deferred exchange pursuant to Section 1031 of the Internal Revenue Code. You will enter one or more agreements {the Assignment Agreement(s)} with the QI under which the QI (For Forward Starker transactions): 1. Takes an assignment of title to your relinquished property. 2. Takes possession of all funds and boot received from the buyer of your relinquished property. 3. Settles all encumbrances, expenses of sale, and conditions of sale for the relinquished property. 4. Transfers title for the relinquished property to your buyer. 5. Takes an assignment of title to your replacement property. 6. Takes possession of all funds and boot provided to the seller of the replacement property. 7. Settles all encumbrances, expenses of sale, and conditions of sale for the replacement property. 8. Transfers title for the replacement property to you, and 9. Receives a fee for their services. The QI acts like a "traffic cop" or project coordinator… making sure the transaction proceeds within the prescribed time limits. Often, the assignment agreements require the QI to perform this function – and provide remedies if the QI doesn't.		
Restriction: Who can be your QI? You can have no pre-existing business or financial relationship with your QI. The QI cannot be your current attorney, tax practitioner, accountant, real estate agent, or any close relative. Nor can anyone who has served in those roles during the last two years be your QI. If you are paranoid and reading between the lines you probably already get this. Your QI: • Must be someone you barely know; to whom • You must entrust substantial assets, your money, and your business relationships; and on whom		

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• You must rely to get things done on a tight and unforgiving schedule, in an environment where • Plenty can go wrong. And now, the clincher: Only one state (Nevada) licenses 1031 Accommodators. Seven states, including California, require Accommodators to be bonded and/or to maintain errors and omissions insurance, but it is difficult to verify that proper coverages have been obtained and maintained. State required minimum coverage may not cover your potential loss. For this reason, Steven Roy Management \ Cambyses Capital recommends you use only established deep-pocket independent or "institutional" Accommodators such as those attached to major title/escrow companies. Make sure this is not your QI's first rodeo. Entrusting the QI role to "that lawyer-guy who handled Uncle Dave's DUI" is a recipe for disaster. (Professional Note: Treas. Reg. §1.1031(k)-1(g)(4) outlines the QI's function and role in the transaction.)		
Transaction Reporting		
Form 8824 You, or a qualified tax professional, report the IRC §1031 exchange to the IRS on *Form 8824, Like-Kind Exchanges*. File Form 8824 with your tax return for the year in which the exchange occurred. Form 8824 asks for: • Descriptions of the properties exchanged • Dates that properties were identified and transferred • Any relationship between the parties to the exchange • Value of like-kind and other property received • Gain or loss on sale of other (non-like-kind) property given up • Cash received or paid; liabilities relieved or assumed		

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• Adjusted basis of like-kind property given up; realized gain Recent versions of Form 8824 also require you to disclose Drop & Swap transactions (See *“Drop and Swap”* and *“State Tax Treatment of IRC §1031 Transactions,”* below). If you do not follow all the rules for like-kind exchanges, you incur taxes, penalties, and interest on your transactions. *Cautionary Note:* Be wary of anyone who promotes improper use of like-kind exchanges. Their sales pitch may encourage you to exchange non-qualifying vacation or second homes. Many like-kind promoters refer to them as “tax-free” exchanges not “tax-deferred” exchanges. You may also be advised to claim a tax deferred exchange despite the fact that you have taken possession of cash proceeds from the sale. Consult a qualified tax professional and refer to IRS publications for more information. (Google: “IRS Publications 1031 Exchange.” IRS Publication 544 contains the most detailed discussion.)		

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Transaction Arithmetic		
In this relatively simple example, based loosely on a real transaction, you relinquish a property that you have operated for a number of years and exchange it for replacement property of a similar kind (No Boot). The Example compares the tax and basis effects of a straight sale vs. an exchange.		

Client Generic

Hypothetical Sale of Facility

Straight Sale -- Estimate of Proceeds and After-Tax income

Estimate Gain On Sale - Relinquishment (And Allocate to Capital and Recapture)			
Contract Price	1,700,000		
Cost of Sale (Estimate 9%)	153,000		
Net Sales Price	1,547,000	1,547,000	
Building	486,000		38.63%
Land	694,000		55.17%
Capitalized Acq Expense	33,927		2.70%
Improvements	44,045		3.50%
	1,257,972		100.00%
Previous Depreciation	167,717		
Adjusted Basis In Property	1,090,255	1,090,255	
Total Realized Gain on Sale		456,745	
Recapture (1250 and Unrecaptured 1250)		167,717	
Capital Gain (None Deferred)		289,028	

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Item or Description			Responsibility & Date	Completion Date
Total Recognized Gain on Sale		456,745		
Estimate Tax on Recognized Gains				
Tax (Federal Capital Gain and Recapture)		73,815		
Tax (California PIT)		37,287		
Tax (AMT)		7,783		
Tax (NIIT)		9,227		
Total Tax		128,112		
Estimate Cash From Sale and Hypothetical Yield				
Net Sales Price	1,547,000			
Debt Retirement	766,000			
Cash Proceeds From Sale	781,000	781,000		
Total Tax		128,112		
After Tax Cash Proceeds From Sale		652,888		

Client Generic

Hypothetical Sale of Facility

1031 Exchange -- Estimate of Proceeds and After-Tax Income of Replacement

Estimate Recognized and Deferred Gains				
Realized Gain on Sale		456,745		

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Item or Description			Responsibility & Date	Completion Date
Deferred gain; Recapture (1250 and Unrecaptured 1250,)		167,717		
Deferred Gain; Capital Gain on Sale		289,028		
		456,745		
Estimate Tax on Recognized Gain				
Tax (Federal Capital Gain and Recapture)	0.00%	0		
Tax (California PIT)	0.00%	0		
Tax (AMT)	0.00%	0		
Tax (NIIT)	0.00%	0		
Total Tax		0		
Estimate After-Tax Proceeds from Sale				
Net Sales Price	1,547,000			
Debt Retirement	766,000			
Cash Proceeds From Sale	781,000	781,000		
Total Tax		0		
After Tax Cash Proceeds From Sale		781,000		
Estimate Hypothetical Replacement Property Parameters and Cash Required at Close				
Contract Price, Acquired Property		2,300,000		
Closing Costs (Estimate 3%)		69,000		
Accomodation (Estimate 1.25%)		28,750		
Total Capitalized Cost of Acquired Property		2,397,750		

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Book; Apportion to Land	55.17%	1,322,795		
Book; Apportion to Building	44.83%	1,074,955		
Book; Total Capitalized Cost of Acquired Property		2,397,750		
Total Capitalized Cost of Acquired Property		2,397,750		
After Tax Cash Proceeds From Sale		781,000		
Additional Resources Required		1,616,750		
Total Capitalized Cost of Acquired Property		2,397,750		
Loan; Maximum LTV	70%	1,610,000		
Loan Origination & Placement (Estimated)	1.50%	24,150		
After Tax Cash Proceeds From Sale		781,000		
Additional Boot Required at Closing		30,900		
Total Tax on Recognized Gain		0		
Additional Boot Required at Closing		30,900		
Minimum Total Boot and Cash Required to Close		**30,900**		
(Additional boot may be required for rent prorations, utility escrow charges, tenant damage deposits transferred to the buyer, or other non-transaction costs)				
Estimate Tax Basis and Apportionment of Replacement Property				
Total Capitalized Cost of Acquired Property		2,397,750		
Deferred Gain on Exchange of Property		456,745		
Tax; Carrying Basis of Acquired Property		1,941,005		
Tax; Apportion to Land	55.17%	1,070,817		

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Item or Description	Responsibility & Date	Completion Date
Tax; Apportion to Building 44.83% 870,188 Tax; Carrying Basis of Acquired Property 1,941,005		
Superficially, it appears that the IRC §1031 exchange "saves" approximately $129,000 of tax expense at the cost of about $31,000 of additional transaction expense. This is how realtors usually "sell" IRC §1031 exchange transactions to their clients (though they don't usually mention the additional costs). That superficial observation, however, fails to account for several aspects of the transaction: • In a fully tax deferred exchange transaction (no-boot) you receive no reinvestment cash at close of escrow. That cash receipt is deferred along with the tax until you dispose of the acquired property in a taxable transaction. The present value of the subsequent cash receipt is, accordingly, diminished. • The tax basis adjustment to the acquired property reduces the depreciable basis in that property, thus reducing the amount of "shelter" that depreciation provides. Over the course of the acquired property holding period this increases reported taxable operating income from the property. • Suspended passive losses are not triggered by an IRC §1031 (as they are in a disposition). The present value of tax savings from recognition of passive losses (that are forgone in the IRC §1031 exchange) may exceed the present value of deferred gain reporting. In light of these factors, a more sophisticated approach to investment analysis is usually required. Some elements of that approach are outlined below.		

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State Tax Treatment of IRC §1031 Exchanges		
General Rule: State Conformity with IRC §1031 – With Local Interests Protected Most states have adopted "conformity" statutes that synchronize their tax code to the Internal Revenue Code. With a single exception (Pennsylvania), state tax rules for determining whether an IRC §1031 exchange has taken place are loosely consistent with Federal rules. Pennsylvania's code does not conform to Federal; IRC §1031 transactions pay PA tax as if they were a completed sale. The states have adopted both procedural requirements and local variations that affect state taxation of Federally sanctioned transactions. Those variants include: • Continued recognition of like-kind exchanges involving personalty or intangibles. • State Mandatory Withholding applied to the sales price, transaction proceeds, or net gain; • Exemptions from State Mandatory Withholding; • "Single State" transaction requirements; • Claw-back rules; • Extended periodic (annual) reporting requirements. • Different (generally narrower) interpretations of like-kind rules; and • A jaundiced view of variations from the presumed norm for IRC §1031 transactions, (e.g. an acquired aversion to drop and swap or post transaction refinancing.) In addition, differences between state and federal depreciation or amortization statutes and capitalization conventions alter state adjusted basis calculations and dictate a more encompassing planning approach to these transactions. Resident Note: California conforms to IRC section 1031 under CA Revenue and Taxation Code (R&TC) sections 18031 and 24941. California has not (as of 12/15/2019) adopted federal restrictions that limit deferral to transactions in real property. Like kind transactions in Personalty (Tangible or Intangible) still qualify for deferral in California.		

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State Mandatory Non-Resident Withholding:		

Several states implement mandatory non-resident withholding taxes that must be withheld and paid over by the closing agent when property is transferred to a buyer. (In California realty transactions, the escrow officer is the withholding and payment agent.) Closing agents withhold a stated percentage of the gross sales price (or, in some states, net gain) at the time a deed is recorded. Exemptions from the withholding requirement are available in some states. However, you must apply for withholding exemptions prior to closing the relinquished property. Currently, the following states provide exemptions and require applications:

California	Maryland	Rhode Island
Colorado	Mississippi	South Carolina
Georgia	New York	Vermont
Hawaii	North Carolina	West Virginia
Maine	Oregon	

Review your state rule before closing… things change rapidly and states are becoming more aggressive about collecting pre-paid/estimated taxes.

New Jersey also has mandatory withholding tax for non-resident sellers. Sellers can complete the *Nonresident Seller's Tax Declaration* at closing. (Check Box Number 7 and circle "1031.")

California withholding requirements apply to both California residents and non-residents who sell real property in California. In an IRC §1031 exchange, the exemption request is be made (On CA FTB Form 593) with respect to the relinquished property and boot of up to $1,500.

Failure to request the exemption (or file it) mandates withholding. Withholding is considered cash Boot in the transaction – and results in partial or complete state recognition and taxation.

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Return Requirement: Many states require that both residents and non-residents file a return in the year a property located in their jurisdiction (or subject to their tax regime) is exchanged. {Note: if the property (located in the state) was income producing, a return is generally required even if no exchange or sale has taken place.} Some states have state specific reporting forms (which they may supplement with a copy of the federal return), others require a copy of federal form 8824. Review the filing requirement with qualified local counsel. ***"Single State" Restrictions:*** Several states (notably Mississippi and Vermont) require that both the relinquished property and the acquired property be located (used) within their jurisdiction. If either property is located outside their jurisdiction, these states treat the transaction as a closed sale and acquisition; and impose state tax on the realized gain. (Note that both Mississippi and Vermont also have State Mandatory Withholding. File the exemptions!) ***Effect of Disparate State Rules:*** A number of states (California among them) do not fully conform to Federal capitalization, depreciation, bonus depreciation, and amortization rules. In these states, adjusted basis in the relinquished property, the realized gain on the transaction, the recognized gain due to boot received, and recapture amounts differ from their federal counterparts. This has both planning and reporting implications. First, if you want the transaction to be truly "tax free," (both state and federal taxation deferred to the greatest extent possible), your planning and reinvestment strategy must reflect the worst-case-scenario as between state and federal tax outcomes. This implies that a cursory review of the federal aspects of the transaction will not suffice. California, for example, has less generous bonus depreciation regimes than the IRC allows {CA IRC §179 expense is limited to $2,000. CA did not adopt any of the transitory bonus depreciation scenarios (50% or 100%) in the federal statute}. Hence, both realized gain and depreciation recapture will be smaller for state purposes than for federal (unless the property is fully depreciated under both agency's rules). Not all states have this configuration. (Federal/State differences are certain in Pennsylvania, probable in California.)		

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Second, basis in the acquired property is determined (at least in part) by the adjusted basis of the relinquished property and the recognized gains in the transaction. Consequently, there may be a quasi-permanent difference for basis and annual depreciation of the acquired property for federal and state tax purposes. This difference is common, even in the absence of a deferral transaction. Your state tax records and reporting must accommodate that difference for as long as you retain the acquired property. If you evaluate alternative investments based on either after tax ROI or NPV, the model must also reflect these federal/state tax differences… Federal taxable income is not a good proxy for state taxable income in these calculations. ***Claw-back Rules:*** If you exchange property in one state for property in another state, the Fed eventually collects the deferred tax when the acquired property is sold in a taxable transaction. Federal reach extends everywhere. State tax administrators fear the deferred tax is gone forever. This fear becomes particularly acute if the investors are non-residents or they become non-residents subsequent to the transaction. Once the investor and the investment nexus leaves state jurisdiction states have no effective means to monitor subsequent sale of the acquired property and no way to collect their share of the deferred tax. Surprisingly, most states have no formal mechanism to address this issue. Those states either concede that the deferred revenue is lost or rely entirely on taxpayers' integrity to properly report a subsequent taxable sale of the acquired property and to ante-up the state's portion of the tax on that transaction. States that adopt the second approach are often disappointed with the result. (In fairness, it may not be an integrity failure. Most taxpayers are blissfully unaware of interstate tax obligations; Tax preparers are generally under-trained on multi-state tax issues and may not be aware of the obligation either.) Several (two, as we go to publication) states mitigate their concern by extending IRC §1031 treatment only to intra-state transactions (in which both the relinquished property and the acquired property are within their jurisdiction). One state denies IRC §1031 treatment to all transactions (Pennsylvania).		

<table>
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<tr><td>A growing number of states (five, as of today; legislation pending in half of a dozen others) have adopted “Claw-Back” provisions that obligate sellers to report the outcome of transactions that involve out-of-state replacement properties. These provisions require the seller to:

• Report any taxable disposition of the acquired/replacement property;
• Recognize and pay the state’s tax on the previously deferred gain; and
• Claim relief from double state taxation by means of multi-state tax credits (Optional).

In all but one case (California) it is unclear how this provision will be enforced if a non-resident is otherwise not required to file a return in that jurisdiction. California, however, put teeth into its rule. (We suspect other states will follow California’s example.)</td><td></td><td></td></tr>
<tr><td>CA Claw-Back Reporting and Ground Rules:

California requires <u>annual updates</u> to report previously deferred California sourced gains or losses if you:

• Perform like-kind exchanges of California property for property outside of California, and
• Defer any gain or loss under Internal Revenue Code (IRC) Section 1031.

To fulfill this requirement, you must file form FTB 3840, California Like-Kind Exchanges with a California return or to file a separate signed Form 3840 as an information return. Form 3840 is due annually by the extended due date of your tax return. You must continue to file FTB 3840:

• As long as you defer the gain or loss.
• If you exchange the out-of-state replacement property with another out-of-state property as part of another exchange.
• Until you recognize the deferred California sourced gain or loss on a California return.
• Until the owner of the replacement property dies, eliminating the deferred California source gain or loss.
• Until you donate the replacement property to a non-profit organization.</td><td></td><td></td></tr>
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Those unfamiliar with California enforcement policies may be tempted to disregard this requirement. You do so at your own risk. California collections activity is thorough, aggressive, and borderline incompetent. California issues liens and levies at the drop of a hat and is very slow to refund impounded funds or release liens. Filing an information return is a small price to pay to avoid their attentions.		
Even in jurisdictions (such as California) where state and federal law are similar, state agencies often interpret the precedents more restrictively than the IRS.		
Drop and Swap		
Drop and Swap: Context Dissatisfied partners: at some point, every partnership or LLC has some. How do you get rid of them without substantial tax inconvenience? Many real estate partnerships faced this dilemma as the commercial/industrial market awakened from its long slumber. Drop and swap transactions promise an easy solution to this scenario; • The partnership holds a real estate investment that has appreciated over a long period of time. • The partners disagree about partnership continuity, whether to exchange the old property into a new one, or to sell the property for cash and recognize gain. • The partnership dissolves and distributes tenancy in common (TIC) interests in the property (the Drop). • Each former partner is then free to hold or exchange their TIC for other property interests (the Swap). Whether drop and swap transactions deliver on that promise is another matter entirely. Drop and swap attempts an end run around the IRC §1031(a)(2) exclusion of partnership interests from the list of eligible property in like-kind exchanges {See *"What Can (and Cannot) be Traded,"* above}. The non-exchangeable partnership interest is converted to an exchangeable TIC interest. Dissatisfied partners exit stage left with their capital intact but converted to another (tradable) form. Satisfied partners maintain their interests in the property,		

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albeit in a slightly different form with slightly different operating parameters or they receive cash. In theory, everyone lives happily ever after. Except, of course, the IRS and the state tax agency {California Franchise Tax Board (FTB)}.		
IRS (and States') Challenge to Drop and Swap Perpetual cynics; IRS and state tax agencies are inclined to view this transaction as a sham whose sole purpose is an end run around the IRC §1031(a)(2) exclusion of partnership interests from the list of eligible like-kind exchange property. In contrast to the tax optimistic partners, IRS/Agency killjoys are inclined to mention inconvenient details: • The TIC interests may not meet the "holding and intent" requirement; • The TIC may not be a TIC under the broad definition of "partnership" implicit in IRC §§761 and 7701. • The drop and swap, taken as a whole, may not pass the legitimacy smell test under the *Court Holding* doctrine and or Gregory v. Helvering. The objective fact; the agencies' cynicism is often entirely justified makes these details particularly inconvenient. Like the taxpayer, the IRS/Agency are also disinclined to mention things that are inconvenient to their position: Like *Cumberland Public Service*, in which the Supreme Court reached conclusions diametrically opposed to *Court Holding*. That, however, is a whole different kettle of fish. Since the IRS and several state tax agencies (including the CA FTB) require that you disclose drop and swap transactions and are actively examining them, prudence dictates that you have a ready and verifiable answer to at least the Agencies' three most common arguments.		
Holding and Intent: Superficially, the "holding requirement" appears to be satisfied any time either IRC §1221 or §1231 property {that is not subject to any of the exclusions under IRC §1031(a)(2)} is held. However, because this presumption hinges on		

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the property holders' intent, measured at the time of the transaction, the agencies may challenge the presumption. The agency challenge is particularly cogent if the property is merely transiently held prior to another (tax motivated) transaction – as is common in drop and swap transactions. The IRS has made exactly this argument at least five times. • In two cases (*Dollie Click* and *Fred Wageson*) the taxpayer exchanged property, ran it briefly (seven and nine months) as a rental then gifted the property to descendants for use as a personal residence. The Service successfully challenged the validity of the purported IRC §1031 exchanges. • In three cases (*Bolker*; *Magneson*; and *Bonnie Maloney*) taxpayers distributed property from entities, then immediately disposed of it in an IRC §1031 exchange. These taxpayers prevailed even though the holding periods were shorter than those in the previous two cases. What are the essential differences between the cases; • *Click* and *Wageson* converted an IRC §1221 property (not held in entity solution) to a personal residence (after a brief interregnum). This scenario deferred the original taxpayer's tax burden and shifted it to the taxpayer's beneficiary. • *Bolker*; *Magneson*; and *Bonnie Maloney* converted IRC §1221 property (held in partnership solution) to other IRC §1221 property (after brief holding periods). This scenario delayed, but did not shift, the eventual income tax reckoning. The results in *Bolker*; *Magneson*; and *Bonnie Maloney* rely heavily on the taxpayer favorable facts of each case. Even though they stand unchallenged some 30 years after the fact, it may be advisable not to put complete faith in them.		

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Partnership Interest or Tenancy-In-Common? Can you blame them? The agencies are dubious of self-serving assertions that something you have been calling a partnership interest for years suddenly became a TIC when it was no longer convenient for it to be a partnership interest. Fortunately, agency skepticism isn't quite enough to overturn your position. The IRC and Regulations support the agency's skepticism. Under the IRC, the term "partnership" is not limited to legal entities operating as partnerships under state law. The IRC definition extends well beyond legal entities. It includes "a syndicate, group, pool, joint venture, or other unincorporated organization through or by which any business, financial operation or venture" is carried on (IRC §761). Regulations go further, stating that: "tenants in common, however, may be partners if they actively carry on a trade, business, financial operation, or venture and divide the profits thereof." (Reg. § 301.7701-1(a)(2)) It follows (since you have been "carrying on" for years) that the agency need not recognize a change in form if there is no substantive change in operations. Further, if you immediately dispose of your TIC, how do you demonstrate those substantive changes? If you hold on to your interest, what substantive changes establish the bona fides of the TIC, and how long must they be in place? What, at first, seemed like a property-owners' slam dunk has become a rim clank. The Regulations (the same Regulations that create the ambiguity in the first place) answer only part of the question: Under those Regulations "mere co-ownership of property which is maintained, kept in repair and rented does not constitute a partnership." It seems, then, that the TIC is not a partnership if you render only minimal services to your tenants. The Service has, however, never fully defined where the "minimal service" Rubicon lies. In response to the popularity of TIC syndications in the late 90s (many of them in Los Angeles) the Service issued Rev. Proc. 2002-22, which partially addresses the issue. Rev. Proc. 2002-22 states that providing customary services to tenants (utilities, unattended parking, normal repairs and trash removal) does not constitute business activity nor create a partnership.		

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There is some risk in relying on Rev. Proc. 2002-22 for the minimal service definition. Rev. Proc. 2002-22 advocates a fifteen-point test to define a safe harbor in which a TIC will not be considered a partnership. It is not a declaration of substantive rules. More importantly, Rev. Proc. 2002-22 addresses small percentage, marketed interests, in rather large properties. Its application to substantial interests in a recently dissolved partnership remains murky. (Practitioners, however, may be relieved to see that Rev. Proc. 2002-22 cites Rev. Rul. 75-374 for at least some of its authority. Given Rev. Rul. 75-374's provenance and history, it probably constitutes "substantial authority" when it comes time to oppose preparer penalties.)		
Court Holding and Gregory v. Helvering: In typical drop and swap transactions, the exchange (Swap) follows the drop within minutes. The agencies can be excused if they think both the transactions were fully consummated at the partnership level. In *Court Holding*, the Court held that a liquidating corporation was taxable on the gain realized from the sale of its sole asset because the corporation arranged the sale prior to liquidation and distribution of the asset. The agencies see drop and swap transactions (especially those in which the exchange takes place immediately after the drop) as entirely analogous… They view the transaction as taking place at the partnership level with the proceeds distributed after the transaction. Hence, they view the transaction as they would any other taxable sale of partnership assets followed by distribution of the proceeds. In this view, the partners are taxable on their share of the partnership gain and recapture items, regardless of what they did with their share of the proceeds. *Court Holding* stands in contrast to another decision (*Cumberland Public Service*) rendered about five years later. In *Cumberland*, the Court found that the shareholders, not the corporation, negotiated the sale of the corporation's assets after its dissolution. Thus, the corporation was not taxable on the (near immediate) sale of its assets, its shareholders were. Cumberland supports the outcome most drop and swap transactions aspire to. The essential difference between *Court Holding* and *Cumberland* is who did the negotiation! It may seem like splitting hairs (and Justice Black, who wrote both decisions would agree with you), but that small change in fact pattern leads to entirely different outcomes. *Court Holding* is the IRS' go-to position <u>unless there is documentation to</u>		

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the contrary. That documentation can be problematic for closely held partnerships in which one member customarily negotiates on the partnership's behalf. If that same member negotiates the swap, there is little to distinguish it from ordinary partnership activity. The agencies love this kind of stuff! Nonetheless, without a transaction diary you have little or no effective defense to a *Court Holding* based argument… unless you are willing to wait.		
Remediating drop & swap issues. Time is the most effective antidote for holding/intent and *Court Holding* issues. It also allows room to establish that a real change in organization and operation has taken place, thus remediating the partnership classification issue as well. In an ideal scenario: 1. The members agree that management/investment change is warranted; 2. The partnership/LLC dissolves, distributes tenancy in common interests to the members/partners; 3. A management company operates the property and distributes the proceeds in a way that looks a lot like a TIC (this requires change to fund handling, vendor/bank payments, and the property service matrix); 4. Each of the former members/partners reports their distributive share of the TIC's income and expenses on their own tax return. 5. Sometime after the drop, the former member/partners swap their interests in an IRC §1031 exchange they personally negotiate at that time. This addresses the primary issues that agencies raise on examination; 1. It establishes that there is a non-tax business reason for the transaction; 2. It creates strong evidence the former partnership interest really has become something else; 3. It also becomes evident that the TIC is being "held," though it does not necessarily clarify your "intent" while holding the interest (c.f. *Click, Wagenson,* or *Bolker* among others); 4. It dissociates the swap from the drop. *How much time is enough?* The idealized scenario contemplates a well thought out "amicable divorce." However, drop and swap transactions frequently occur because one or several member/partners Want-Out-Now! Often, they		

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want out because they think they can do better elsewhere – but need the resources tied up in the existing property to make that happen. They fear the better opportunity will go away. Those members/partners usually don't want to hang around, and the other member/partners often don't want them to. Turning management over to a management company reduces the Managing Member's income. Real discussions can become anything but amicable. When tax professionals suggest the swap follow the drop by enough time for a tax cycle between the return for the dissolved entity and the swap (the minimal best-practice suggestion) they are often greeted with incredulity, if not outright derision. Suggest that two years pass between drop and swap, and … woe betide thee, friend. (There is some, limited, evidence that the agencies consider two years to be a threshold; c.f. PLR 8429039) Often, the best that can be done under these circumstances is to 1. Negotiate as much lead time as possible, 2. Require each of the member/partners to negotiate their own swap after the drop, 3. Document the transaction in detail (not just the financial aspects but the negotiations as well), and 4. Hope for the best. Practice Note: Document your advice and the transaction chronology in the client file. Clients have a peculiar habit of "forgetting" that you advised caution when they get hit with a couple of hundred thousand dollars of tax, interest, and penalties.		
Professional Notes and References: Commissioner v. Court Holding Co., 324 U.S. 331 (1945); United States v. Cumberland Public Service Co., 338 U.S. 451 (1950); Dollie H. Click, 78 TC 225 (1982); Fred S. Wagenson, 74 TC 653 (1980); Bolker v. Commissioner, 760 F.2d 1039 (9th Cir., 1985); Magneson v. Commissioner, 752 F.2d 1490 (9th Cir. 1985); Bonny B. Maloney, 93 TC 89 (1989)		

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Rev. Proc. 2002-22, 2002-1 CB 733, 03/19/2002, IRC Sec(s). 1031; Rev. Rul. 75-374, 1975-2 CB 261, IRC Sec(s). 761 Because of their frequency and variability, there is <u>probably</u> "substantial authority" for tax practitioners to recommend or report drop and swap transactions as IRC §1031 exchanges without exposure to preparer penalties under IRC §6694. Whether the reporting would pass the higher "more likely than not" standard is an open question.		
Effect on Future Depreciation and Sale of Acquired Property (In Development)		
Related Parties (In Development)		
IRC §1031(f) modifies the transaction rules if either the buyer of the relinquished property or the seller of the replacement property are related to the seller/buyer.		
Practicalities: Early in the process, determine whether any of the parties to the transaction are related. It is especially important that the Qualified Intermediary is not a related party. {Review IRC §1031(f)}		
Alternatives to IRC §1031 Exchanges (In Development)		
Opt Out: Suspended passive losses are not triggered by an IRC §1031		

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