A New Landscape:
1031 Exchanges & Tax Reform

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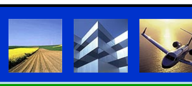
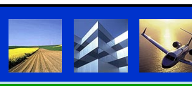
TODAY'S OBJECTIVES



- Provide a thorough overview of 1031 exchanges
- Review their many benefits for ***YOU*** and your customers
- Examine the requirements of a valid exchange
- Review basic tax consequences of exchanging
- Look at Threats to Repeal or Limit Section 1031and Efforts to Preserve 1031
- Review Impact of the Tax Cuts & Jobs Act on 1031
- Q & A

1031 EXCHANGE



WHAT IS A 1031 EXCHANGE?

Section 1031 of Internal Revenue Code provides no gain or loss will be recognized on the exchange of real property held for productive use in a trade or business or for investment.

Not for primary residences, flips or most vacation homes.

1031 EXCHANGE

WHAT IS A 1031 EXCHANGE?

It's the sale of real property used for trade or business or as investment followed by the purchase of another within 180 days and linked together by the necessary documentation.

- Based on continuity of investment – the continuation of the initial investment.
- Exchanges have been allowed since 1921.

How *YOU* Can Benefit from 1031

KNOWLEDGE = POWER

Why Should *YOU* know about 1031 exchanges?

- Today's customers expect us to know everything!
- Knowing about exchanges leads to
  - More listings
  - More sales
  - More commissions
  - More opportunities for referrals
  - More exposure
  - **REFERRALS! LOTS OF REFERRALS!**

Tax Facts and Rates

The Power of a 1031 Exchange

TAX FACTS AND RATES

FACTS

- Taxes are due on capital gain
  - *Due on appreciation*
  - *Short-term capital gains are taxed as ordinary income*
  - *Maximum long-term capital gain tax rates apply to individuals who held property more than 12 months*

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TAX FACTS AND RATES

CAPITAL GAINS*

- 20% for taxpayers with ordinary incomes exceeding $400,000 ($450,000 for married taxpayers)
- 15% for incomes more than approx. $36,000 ($71,000 for married taxpayers) and less than $400,000 ($450,000 for married taxpayers)
- 0% for incomes less than approx. $36,000 ($71,000 for married taxpayers)

**Consult tax advisor to determine actual tax rates.*

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TAX FACTS AND RATES

"NEW" 3.8% NET INVESTMENT INCOME TAX

- *Tax went into effect 1/1/2013; part of Affordable Care Act (Obama Care)*
  - *Many are not expecting this additional tax on their gain*
- *Applies to unearned income (rental income, capital gains, dividends, non-qualified annuities)*
- *Affects individuals, estates and trusts with modified gross annual income exceeding $200,000 and married couples exceeding $250,000*

TAX FACTS AND RATES

DEPRECIATION MUST BE RECAPTURED

- *Generally taxed at 25% regardless of tax bracket.*

STATE INCOME TAX

- All states with an income tax regime either follow the federal code or have adopted their own version of like-kind exchanges *except one*.
- Pennsylvania typically does NOT recognize a 1031 exchange unless a c-corp.
  - Tax is owed by PA residents regardless of where property is located and non-residents selling PA property
    - *Definitely creates a disadvantage to non-residents and discourages real estate investment in PA*
  - There have been bills introduced in the PA House and the PA Senate in recent years but none have passed

STATE WITHHOLDING TAX

- Many states have implemented a non-resident withholding tax.
  - Most allow Exchangers to request an exemption but they must file paperwork *with the state prior to closing.*
    - *Have seen the request denied.*
    - *Local examples include MD, NY, DE, WV*
  - New Jersey allows required form to be signed at closing.
    - *Must pay withholding on "boot"*

1031 vs. SALE

ASSUMPTIONS

- Individual owned property for many years
- Annual Salary of $125,000 and $50,000 of add'l income (interest, dividends, rental income)
- Paid $250,000
- Made no capital improvements
- Took $150,000 in depreciation
- Selling for $500,000

1031 vs. SALE

ASSUMPTIONS

- Capital gains of $250,000
- With $175,000 of income, falls into 20% capital gains tax rate
- Subject to 3.8% Net Investment Income Tax
- Subject to highest income tax bracket of 37%
- Deprecation recapture of $150,000 @ 25%
- May be subject to Alternative Minimum Tax (AMT)

1031 vs. SALE

	Taxable Sale	1031 Exchange
Sale Price	$500,000	
Capital Gains	$37,500*	
3.8% Net Investment Tax	$9,500	
Depreciation Recapture	$37,500	
Federal Tax Liability	$84,500	
Net Proceeds	$415,500	
Buying Power (30% down)	$1,385,000	

**Calculated at 15%. Actual amount could be higher.*

1031 vs. SALE

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Capital Gains	$37,500*	0
3.8% Net Investment Tax	$9,500	
Depreciation Recapture	$37,500	0
Federal Tax Liability	$84,500	0
Net Proceeds	$415,500	$500,000
Buying Power (30% down)	$1,385,000	**$1,666,667**

**Calculated at 15%. Actual amount could be higher.*

1031 vs. SALE

- Immediately avoids $84,500 federal tax liability
- Able to invest all proceeds
- Leverage extra $84,500
- Acquire new property worth $281,667 MORE than you could if you paid the tax
- Collect higher rents from Day 1
- More depreciation available
- Enjoy greater appreciation long-term

1031 BENEFITS

- Immediate tax deferral
- Time value of deferral
- Avoid higher income tax bracket and 3.8% Net Investment Tax
- Potentially avoid Alternative Minimum Tax (AMT)
- Greater Buying Power
- Less management
- Consolidation of multiple properties
- Fresh depreciation schedule
- Create new cash flow
- Diversification of property types or locations
- Relocation or expansion of business
- Future conversion to primary residence or vacation home
- Possible elimination of gain
- Estate preservation with stepped up basis

Unlocking the Power of Exchanges

Overview of 1031 Exchanges

PARTIES & THEIR ROLES

- **EXCHANGER** is taxpayer deferring the gain
- **BUYER** of Relinquished Property
- **SELLER** of Replacement Property
- **REAL ESTATE PROFESSIONAL**
- **TAX ADVISOR**
- **ATTORNEY**
- **QUALIFIED INTERMEDIARY**

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LIKE-KIND DEFINED

REAL PROPERTY (REAL ESTATE) EXCHANGES

- Any real property used for business use or investment can be exchanged
- "Like-Kind" refers to the nature or character of property
  - *Specific type of property not essential*
- Located within 50 states, D.C. or selected territories
- Can buy or sell multiple properties

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LIKE-KIND EXAMPLES

- Examples of like-kind real estate
  - Duplex, apartment building, rental house
  - Office building, warehouse, shopping center
  - Land
  - Tenant-in-Common (TIC) interest
  - Conservation easements, DST interests
  - Leasehold interest of 30 years (including options)
  - Cell tower easements, utility easements
  - Oil and Gas Royalties; Mineral Interests

LIKE-KIND EXAMPLES

- Examples of ***non*** like-kind property
  - Personal residence and most vacation homes
  - Partnership interests
  - Mortgages and notes
  - Cash
  - All tangible and intangible non-real estate assets
  - Dealer property and inventory
  - Stocks

QUALIFIED USE

- Holding period not defined in regulations
- One year is good rule of thumb
  - Taxpayer Relief Act of 1997 defined "long-term" investments as held longer than one year
  - Two year "safe harbor" if converting to/from personal use
- Intent of taxpayer is key
  - *Look at the picture you have painted*
- Personal use must be minimal (§280A)

Consult your tax and/or legal advisor to determine what is best for you.

SAFE HARBORS

SECURITY OR GUARANTEE ARRANGEMENTS

- Taxpayer is entitled to obtain security for exchange funds
  - Mortgage, deed of trust or security interest (other than cash or cash equivalent)
  - Stand-by letter of credit
  - Third Party Guarantee from parent or affiliate company

SAFE HARBORS

QUALIFIED ESCROW OR QUALIFIED TRUST

- Qualified escrows or qualified trusts can be used as an additional layer of security
- Agreement between Taxpayer, QI and trust or escrow officer of a financial institution
- Requires Taxpayer to provide written authorization before trust or escrow officer will approve withdrawal of funds

SAFE HARBORS

USE OF A QUALIFIED INTERMEDIARY (QI)

- QI acts as "middleman" to facilitate an exchange
  - Acquires, holds and conveys both properties
  - Prepares necessary exchange documentation
  - Controls exchange proceeds
  - Coordinates details with closing agents
  - Keeps Exchanger aware of time deadlines
- Who is qualified?
  - Cannot be a close relative, employee, partner or have provided real estate, law or tax services in past 2 years

SAFE HARBORS

INTEREST AND GROWTH FACTOR

- Taxpayer has right to earnings on exchange funds
- Interest earnings are taxable
- Can elect to include or exclude interest from acquisition of replacement property
- Must be restricted in same manner as principal

DOCUMENTATION

- 1031 Exchange Agreement
  - *Places restrictions on exchange funds*
  - *Must be amended to identify replacement property*
  - *Must be signed prior to the transfer of the relinquished property*
- Assignment of Agreement of Sale
- Written Notification to Buyer and Seller

TIME PERIODS

- Time periods begin with conveyance to buyer of first relinquished property
  - **45-Day Identification Period**
    - *Requires written identification letter signed by Exchanger*
    - *Must be unambiguously identified*
  - **180-Day Exchange Period**
    - *Requires acquisition of all replacement property*
    - *May require extension if it falls after due date tax of tax return*

Time periods run concurrently and are based on calendar days.

IDENTIFICATION RULES

- **Three Property Rule**
  - *Up to three properties; unlimited value*
- **200% Value Rule**
  - *Four or more properties cannot exceed 200% value of relinquished property*
- **Exceptions**
  - *95% Rule*
  - *Anything acquired within 45-Day ID Period*

DISASTER EXTENSIONS

- Must be declared a federal disaster area and eligible
  - Hurricanes, tornados, floods, wildfires, terrorist attacks
- Rev. Proc. 2007-56 provides a time extension of either 120 days or to the last day of the authorized general extension period, whichever is later;
- Clarifies who qualifies for the extensions.
- *Note extensions are not automatic and they do not apply to state or local states of emergency or all federal disasters. You must meet the criterion of the Rev. Proc.*

SAME TAXPAYER

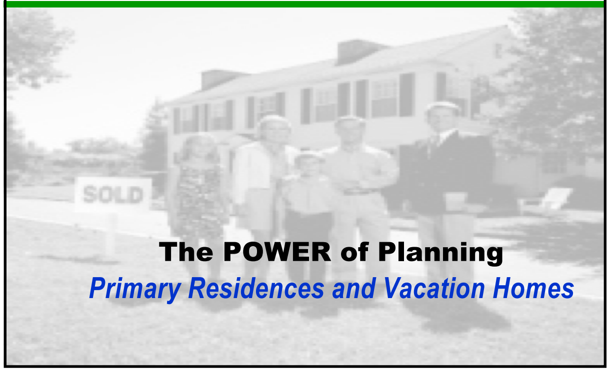
- Title to the replacement property must be vested with same taxpayer (owner) as the old property.
  - Any taxpayer (individual or entity) can exchange.
  - Exception is a disregarded entity
    - *Single member limited liability company*
      - *Sole member must be taxpayer who sold relinquished property*
      - *Must be treated as disregarded entity for tax purposes*
    - *Revocable living trust*
    - *Illinois Land Trust*

EXCHANGE PROCEEDS

- Exchanger cannot have control of the exchange funds, including earnest money deposits.
- Exchange agreement places restrictions on funds.
- Typically held by the QI
  - Exchanger has right to earn interest on exchange funds
  - Interest is restricted in same manner as principal
  - Various levels of security are available for exchange funds

WHEN $ CAN BE RELEASED

- On 46th day if no replacement property identified;
- After 45th day and all identified replacement property is acquired; or
- On 181st day.
  - If one replacement property is acquired and others are identified but no longer desired, no funds can be released until end of 180-Day Exchange Period.



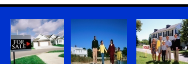
The POWER of Planning

Primary Residences and Vacation Homes

SECTION 121

- Applies only on sale of principal residence
- Effective 1997
  - Replaced old section 1034 "Primary Residence Rollover"
  - Replaced old section 121 "Once in a Lifetime Exclusion"
- Exclusion
  - $250,000 (single taxpayer) and $500,000 (married filing jointly)

QUALIFICATIONS



- During past two years (or 24 months of last 60):
  - Must have owned the property and
  - Utilized as primary residence.
- Can only claim exclusion once every two years
- If property was acquired in a 1031 exchange, you must OWN the property for at least *five* years before qualifying for the exclusion.
- Can never exclude depreciation

121: CHANGES IF FORMER RENTAL

The Housing Assistance Tax Act of 2008

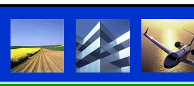
- Included a modification to the Section 121 exclusion
- Modification affects taxpayers who exchange into a residential property and then later convert the property to a personal residence.
- Effective January 1, 2009, the Section 121 exclusion does not apply to gain from the sale of the residence that is allocated to periods of "non-qualified use."
  - Non-qualified use refers to periods that the property is not used as the taxpayer's principal residence.
  - This change applies to use as a second home as well as a rental.
  - Non-qualified use before 1/1/2009 okay

121: CHANGES IF FORMER RENTAL

The Housing Assistance Tax Act of 2008

- H & W exchange into residential property 2009
- Rent for 3 years; move in for 3 years;
- $300,000 gain at sale
- Recapture depreciation first, then apply this formula to the balance:
  - *Numerator: all years of non-qualified use after 2008*
  - *Denominator: all years of ownership*
- Result under new law:
  - *3/6 ($150,000) Ineligible for exclusion*
  - *Thus: 3/6 ($150,000) is eligible*

VACATION HOMES



- Rev. Proc. 2008-16 provided a safe harbor for the exchange of vacation homes
  - Must limit personal use to 14 days in each of the two 12 month periods prior to the sale of the old one and after the purchase on the new one;
  - Must rent the property for at least 14 days in each of the two 12 month periods prior to the sale of the old one and after the purchase of the new one;
  - If you fail to comply, must report as a taxable sale.

MIXED USE PROPERTY

- Mixed use property (used for business use or investment and also as primary residence) can qualify for 1031 and section 121 exclusion
  - Examples of mixed use property:
    - *Farms*
    - *Bed & Breakfast*
    - *Multi-unit building*

Great way to maximize tax strategies.

Maximizing the Tax-Deferral

The Tax Consequences of a 1031 Exchange

TAX CONSEQUENCES

- To maximize the tax deferral, you must acquire a replacement property of equal or greater net ***VALUE*** and ***EQUITY***.
- Value and equity takes closing costs into account.
- A trade down in property value or equity is taxed just on the trade down.
  - When trading down, your tax advisor can help you determine if the 1031 exchange still makes sense.

BASIS & DEPRECIATION

- Old basis is carried forward.
  - Increased by any increase in property value.
- Continue on old depreciation schedule until out of depreciation.
- Increase in value is depreciated as new asset.
  - Replacement property could have two depreciation schedules.
  - Could opt out of this treatment and depreciate at the lower basis.

GREAT LOOPHOLE

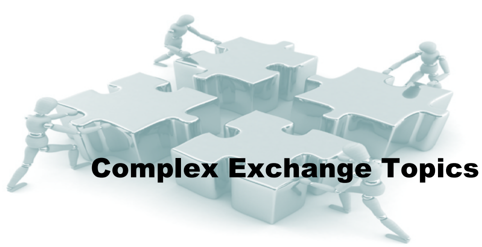
- Once the exchange is completed, there is no reason one cannot refinance and pull out some equity.
  - This equity can be used to make improvements in this property, acquire other property or for whatever purposes your client wishes!

FAILED 1031 SPANNING TWO YEARS

- Must have "bona fide" intent to exchange.
- If exchange proceeds paid to taxpayer in second tax year, transaction can be reported as an installment sale.
  - Tax due in second tax year *not* year of sale. [Reg 1.1031(k)-1(j)(2); Temp Reg 15a.453-1(b)(3)(i)]

REPORTING 1031 EXCHANGES

- Section 1031 exchanges must be reported on IRS Form 8824 “Like-Kind Exchanges”
- Must be reported for tax year in which first relinquished property was sold regardless of when the replacement property was acquired
- Related party transactions must be disclosed



RELATED PARTY ISSUES

- Revenue Ruling 2002-83:
- *Use great caution when exchanging with a related party.*
- Possible exceptions:
  - Related party is completing an exchange
  - Related party is paying MORE tax than Exchanger would have paid if it wasn’t a 1031
  - Acquiring larger undivided interest in property already owned
- Two Year Holding Period
  - Tolling

WHO IS A RELATED PARTY?

- Family members such as siblings, spouse, ancestors and lineal descendants.
- Individual and corporation where more than 50% in value of the stock is owned directly or indirectly by or for such individual.
- Two corporations part of the same control group.
- A grantor and a fiduciary of the same trust.
- A fiduciary and a beneficiary of the same trust.
- A fiduciary of a trust and the fiduciary or beneficiary of another trust where the same person is the grantor of both trusts.
- A fiduciary of a trust and a corporation more than 50% in value of the outstanding stock in which is owned, directly or indirectly, by or for the grantor of the trust.

WHO IS A RELATED PARTY?

- A corporation and partnership if the same persons own more than 50% in value of the outstanding stock of the corporation and more than 50% of capital interest or profits interest in the partnership.
- An S corporation and another S corporation or a C corporation if the same persons own more than 50% of the value of the outstanding stock of each corporation.
- Two partnerships in which the same persons own, directly or indirectly, more than 50% capital interests or profit interests.
- A partnership and a person owning, directly or indirectly, more than 50% capital interests, or profits interest, in such corporation.

1031 & SELLER FINANCING

- A 1031 exchange can be combined with an installment sale (§453) if note spans 2 or more years
- One of following strategies can be used to avoid installment sale treatment and maximize the tax deferral thru 1031:
  1. Exchanger buys note from QI before acquiring new property
  2. Note due within 180 days (before new property acquired)
  3. Note used as consideration for replacement property
  4. Note sold on open market (usually at loss)

IMPROVEMENT EXCHANGES

- Allows Exchanger to increase FMV of replacement property before taking title
- Seller can make improvements or title can be transferred to a builder or QI
- Only exchange proceeds invested within 180-Day Exchange Period will qualify
- Detailed 45-day identification required
- Increased cost; additional planning needed

REVERSE 1031 EXCHANGES

- Provides alternative when replacement property must be acquired before conveying relinquished property
- Requires more planning; additional costs
- IRS blessing (Revenue Procedure 2000-37)
  - Effective September 15, 2000
  - Can complete a successful reverse exchange outside 180-day "safe harbor"

REVERSE 1031 EXCHANGES

- Exchange Accommodation Titleholder (EAT) acquires either
  - replacement property from Seller, or
  - relinquished property from Exchanger
- EAT agrees to hold for up to 180 days
- EAT leases property to Exchanger
  - Term of 180 days
  - $1 lease

REVERSE 1031 EXCHANGES

- Exchanger loans the EAT funds to buy property
  - Note and mortgage to Exchanger from EAT
    - Typically no interest loan
    - 180-day term
  - Third party financing can be arranged
    - EAT signs non-recourse mortgage
    - Exchanger sign note
    - Most lenders now very cooperative
    - Need to use lender that will keep note, not sell off ASAP

PARTNERSHIP ISSUES

- Partnerships can exchange under 1031 but individual partners cannot exchange their partnership interest.
  - Partners own an interest in the partnership, not real estate.
  - Cannot exchange partnership interest for another partnership interest.

PARTNERSHIP ISSUES

Partnership or Tenant-in-Common?

- Often have to determine if there is a partnership or not (tenants-in-common).
- If tenant-in-common, each co-owner can do as they wish with their interest (1031 or pay tax)
- Each tenant-in-common has to decide if they will reinvest together or go separate ways.

PARTNERSHIP ISSUES

- Same partnership must acquire new property.
- If some partners want out, the remaining partners can buy exiting partners out before, during or after the exchange.
  - There are tax implications of buying out partners and taxpayer should consult his/her tax advisors.
- Cannot use sale proceeds to buy out partners.
  - Can give exiting partners a note and refinance replacement property after exchange is complete.

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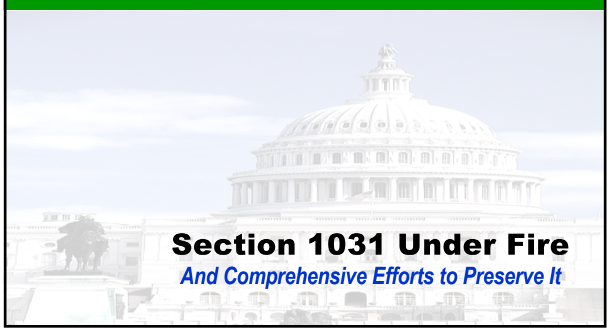


Section 1031 Under Fire

And Comprehensive Efforts to Preserve It

BACKGROUND

PRIOR TO 1/1/2018

Section 1031 of Internal Revenue Code provides no gain or loss will be recognized on the exchange of ***any asset*** held for productive use in a trade or business or for investment.

WHY 1031 PERSONAL PROPERTY?

- 1031 was very advantageous when personal property (capital assets) was fully depreciated.
- Examples of intangible and tangible personal property often exchanged:
  - Vehicle fleets (cars, trains, planes, vessels, trucks, buses, etc.)
  - Furniture, fixtures and equipment
  - Franchise agreements
  - Liquor licenses
  - Farm equipment
  - Livestock
  - Construction equipment
  - Artwork and Collectibles (paintings, musical instruments, cars, coins, etc.)
  - Taxi medallions
  - Copyrights, patents
  - Sports player contracts
  - Race horses

WHY TARGET 1031 FOR ELIMINATION?

Anticipation of new tax revenue through repeal or restriction

- $40.9 billion Repeal Score (cumulative over 10 years)
- $37.1 billion Limitation Score (10 years / Limit gain deferral to $1 million per year)

Discussed as “Pay for” various expenditures

- Lower corporate tax rate
- Infrastructure
- Pension reform

§1031 – TARGET FOR TAX REFORM

Senate Finance Cmte (Senator Max Baucus)
2013 Tax Reform Discussion Draft

- Repeal real property exchanges
- Pooling cost recovery system for personal property
- Eliminates need for personal property exchanges

House Ways & Means Committee (Chairman Dave Camp)
Tax Reform Act of 2014

- Full Repeal of §1031

Obama Administration *FY2015, 2016 and 2017 Proposed Budgets*

- Limit Real Property and Personal Property Exchanges to $1M Annual Gain Deferral Per Taxpayer
- Eliminate Exchanges of Art & Collectibles

HOUSE REPUBLICAN BLUEPRINT FOR TAX REFORM

- Rolled out during summer of 2016
- Starting point for comprehensive 2017 tax reform
- Would permit 100% expensing with unlimited loss carryforward for all depreciable personal property assets and real estate improvements, but *not* land
  - Immediate write off
  - Recapture or capital gain offset by expensing of new property. Would have to be much higher priced asset because you could not expense land.
- Kevin Brady, chair of House Ways & Means, told a group of 500+ REALTORS® they wanted to repeal 1031

UNIFIED FRAMEWORK FOR FIXING OUR BROKEN TAX CODE

- Rolled out September 27, 2017
- Omitted immediate expensing for real estate improvements. This change was a big win for real estate and emboldened argument that Section 1031 exchanges must remain.
- Included a five-year temporary window for the immediate expensing of investments in depreciable assets other than structures. However, the ability to write off (expense) new assets in one year would sunset after five years.
  - "Made after September 27, 2017" statement raises questions about used assets that are "new to you".

MACROECONOMIC STUDY

- Macroeconomic study by Ernst & Young released on March 17, 2015
- Major findings:
  - Would subject businesses and investors to higher tax burden on sale resulting in
    - *longer holding periods (the "lock-in" effect)*
    - *greater reliance on debt financing*
    - *less-productive employment of capital in the economy*
  - Cost of capital will increase, discouraging investment, entrepreneurship and risk-taking and slowing the velocity of investment

MACROECONOMIC STUDY

- Major findings of the EY Study:
  - Would slow economic growth, shrink investment and ultimately reduce GDP, *even if the revenue was used to lower tax rates*
    - *Many real estate investors and small business owners hold real estate in a pass through entity so they would not benefit from lower corporate taxes*
  - The total impact on overall U.S. GDP would be a drop of $8.1 billion each year
  - Total effect of repeal on ten most impacted industries would create impact GDP by $26 billion annually

MICROECOMONIC STUDY

- Microeconomic study focused only on real estate released on July 9, 2015
- Authored by:
  - Professor David C. Ling, University of Florida
  - Professor Milena Petrova, Syracuse University
- Complimented the EY study
- Reviewed 1.6M commercial real estate transactions between 1997 and 2014 *(8824s and CoStar data)*

MICROECOMONIC STUDY

- Major findings of the Ling & Petrova Study:
  - Use of 1031 is widespread
  - Exchanges encourage investment and promote real estate sales activity
  - Exchanges contribute significant federal tax revenue
    - *88% of all exchange properties are eventually sold and taxes paid*
  - Exchanges lead to job creation
  - Exchanges lead to property improvements

NEGATIVE IMPACT OF REPEAL

Economic impact studies prove:

- Broad use and positive economic impact of Section 1031 felt throughout the U.S. economy
- Elimination or restriction will result in:
  - ✓Insignificant new revenue to Treasury
  - ✓Economic contraction
    - $8.1 billion annually (EY Study) to $18 billion annually (The Tax Foundation)
    - 23,000 full-time equivalent jobs will be lost in a variety of sectors (The Tax Foundation)

IMPACT OF REPEALING §1031

- A repeal of 1031 would lead to:
  - Decrease in real estate prices
  - Higher long-term rents in all sectors
  - Longer holding periods
  - Decrease in real estate investment
  - Greater reliance on debt rather than equity and the cost of capital will rise
  - A contracted economy

NAR 1031 SURVEY

- **National Association of REALTORS® (NAR) Survey conducted Spring 2015**
  - 63% of REALTORS® participated in a 1031 between 2011-2014
  - 48% of exchanges involved individuals or sole proprietorships
  - 86% indicated additional capital was allocated for improvements
  - Average holding period of exchange properties was medium to long-term

NAR 1031 SURVEY

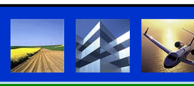
- 40% of 2011-2014 transactions would not have happened without a 1031
- 96% thought real estate values would decrease with a repeal of 1031
- 94% stated a repeal would lead to a decrease in demand for core assets, business and services
- 67% said there would be increased leverage
- 86% said new construction loans would decrease

TAX CUTS & JOBS ACT

TAX CUTS & JOBS ACT

- Tax Cuts & Jobs Act of 2017 was signed on December 22, 2017
  - Real property exchanges were preserved as is
  - Personal property exchanges repealed from 1031
    - Now taxable at time of sale but purchases of new and used personal property assets qualify for immediate expensing (5 years, then phase out)
    - Based on scoring, personal property exchanges accounted for ¾ of the repeal score ($30B)

AMENDED SECTION 1031



- Section 13303 of the Senate amendment revised Section 1031(a)(1) to provide:

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

1245 DEPRECIATION RECAPTURE

- Section 1245 property includes tangible or intangible personal property eligible for depreciation or amortization
  - Examples include furniture, equipment, vehicles, trademarks and copyrights
  - Does not include land and/or improvements

1245 DEPRECIATION RECAPTURE

- Section 1245 property for real property occurs when:
  - Special categories of 1245 - usually agricultural use
    - *Examples: trees, single purpose buildings (chicken coops)*
  - Cost segregation study recharacterized fixtures from real property to personal property for depreciation purposes
    - *Examples: lighting, wall coverings, sprinkler systems*
  - Section 179 Qualified Real Property
    - *Improvements to nonresidential real property **after** the date the property was placed into service*

SECTION 179 EXPENSING

- Section 179 is an immediate expense deduction business owners can take for purchases of depreciable business equipment or software instead of capitalizing or depreciating the asset.
  - Incentive to acquire new equipment
  - Helps businesses grow

SECTION 179 EXPENSING

- TCJA Provides Section 179 Immediate Expensing
  - 100% immediate expensing allowed in Years 1 – 5;
  - 80% immediate expensing in Year 6;
  - 60% immediate expensing in Year 7;
  - 40% immediate expensing in Year 8;
  - 20% immediate expensing in Year 9;
  - 0% immediate expensing in Year 10;

SECTION 179 EXPENSING

- TCJA Increased Maximum Deduction from $500K to $1M.
  - Will be adjusted for inflation.
- TCJA increased phase out threshold from $2M to $2.5M.
  - Will be adjusted for inflation.

SECTION 179 EXPENSING

- Section 179 "Qualified Real Property"
  - *Improvements to **non residential** real property made **after** the date the property was placed into service*
  - *Two categories of Qualified Real Property (QRP)*
    - *Category 1: (a) roofs; (b) heating, ventilation and air conditioning property; (c) fire protection and alarm systems; and (d) security systems*
    - *Category 2: "Qualified Improvement Property" (QIP) includes interior improvements other than (a) enlargement of a building; (b) elevator or escalator; and (c) structural framework*

1250 DEPRECIATION RECAPTURE

- Section 1250 property includes all depreciable real property that is not 1245 real property.
- Replacement property must have equal or greater excess of accelerated depreciation over straight line depreciation
  - Could be an issue when exchanging into land
- Qualified Improvement Property (QIP) can be expensed under Section 179 but recapture provisions must be taken into consideration

SECTION 199A DEDUCATION

- Provides deduction of up to 20% of "qualified business income" for non-corporate taxpayers
  - Could lower the 37% ordinary income tax rate to 29.6% on qualifying income

SECTION 199A DEDUCATION

- Deduction is limited to (a) 50% of W-2 wages or (b) 25% of W-2 wages plus 2.5% of unadjusted basis of qualified property
  - Qualified property includes depreciable real property excluding land
- Unclear how unadjusted basis will be computed in a 1031 exchange
  - Proposed regulations "Unadjusted Basis Immediately After acquisition" (UBIA) as the carryover tax basis of the relinquished property, versus the actual cost of either the relinquished or the replacement property

1031 Exchanges: A New World

The Impact of Tax Cuts & Jobs Act of 2018

QUALIFYING PROPERTY

REAL PROPERTY (REAL ESTATE) EXCHANGES

- Any real property used for business use or investment can be exchanged
- "Like-Kind" refers to the nature or character of property
  - *Specific type of property not essential*
- Located within 50 states, Washington, D.C. or selected territories

LIKE-KIND REAL PROPERTY

- Examples of like-kind real property frequently exchanged:
  - Single family rental
  - Duplex, apartment building
  - Office building, warehouse, shopping center
  - Triple Net Lease (NNN)
  - Farms and ranches
  - Vacant land
  - Tenant-in-Common (TIC) interest
  - Leasehold interest of 30 years or more, including options

LIKE-KIND REAL PROPERTY

- Examples of like-kind real property frequently exchanged:
  - Co-ops
  - Air rights
  - Conservation easements
  - Cell tower or billboard easements, utility easements
  - Oil and gas royalties
  - Mineral interests
  - Timber rights
  - Interest in Delaware Statutory Trust (DST)

NON LIKE-KIND PROPERTY

- Examples of ***non*** like-kind property:
  - Personal residence and most vacation homes
  - Partnership interests
  - Mortgages and notes
  - Cash
  - All tangible and intangible non-real estate assets
  - Dealer property and inventory (flips, spec homes, building lots, etc.)
  - Stocks, interests in a REIT

IMPACT OF TAX REFORM

- Some tangible and intangible assets not eligible for 1031 or immediate expensing
  - Artwork and collectibles
  - Franchise agreements
  - Liquor licenses
  - FCC licenses
  - Distribution rights
  - Coins
  - Sports players' contracts

INCIDENTIAL PROPERTY

- 1031 regs includes an identification rule that allowed you to include personal property incidental to a larger item of property
- Incidental property could not be valued more than 15% of the fair market value of the larger property
- 1031 funds can no longer be used towards incidental property

NEW OPPORTUNITIES

- Cost segregation studies help identify what assets will qualify for immediate expensing if placed into service after 9/27/2017
  - "New to you" allows both new and used assets
  - Could provide a significant deduction in the year of acquisition
  - Could help offset a trade down in value and/or equity
  - Especially valuable when exchanging and the relinquished property had a cost seg study

NEW OPPORTUNITIES

- Expanded Section 179 expensing can allow Taxpayer to make improvements to non-residential replacement property after acquisition
  - to potentially avoid a taxable event due to a trade down in value or equity; or
  - forego an improvement exchange
    - *This is especially advantageous in Pennsylvania where we have to pay duplicate realty transfer taxes*
- Reminder – 2 categories of Qualified Real Property

QUALIFIED OPPORTUNITY ZONES

- Proposed regulations released October 19th
- Preamble states "capital gain from an actual, or deemed, sale or exchange, or any other gain that is required to be included in a taxpayer's computation of capital gain" can be deferred
- The gain must be gain that would be recognized, absent deferral, not later than December 31, 2026 and must not arise from a sale or exchange with a "related person"

QUALIFIED OPPORTUNITY ZONES

- Allowed under TCJA, designed to spur economic development and job creation in distressed communities
- A Qualified Opportunity Zone is an economically-distressed community where new investments, under certain conditions, may be eligible for preferential tax treatment
- Localities qualify as Opportunity Zones if they have been nominated for that designation by the state and that nomination has been certified

QUALIFIED OPPORTUNITY ZONES

- A Qualified Opportunity Fund (QOF) is an investment vehicle that is set up as either a partnership or corporation for investing in eligible property that is located in a Qualified Opportunity Zone
- Investors can defer tax on any prior gains invested in a QOF until the earlier of the date on which the investment in a QOF is sold or exchanged, or December 31, 2026

QUALIFIED OPPORTUNITY ZONES

- If the QOF investment is held for longer than 5 yrs, there is a 10% exclusion of the deferred gain
- If held for more than 7 yrs, the 10% becomes 15%
- If the investor holds the investment in the Opportunity Fund for at least ten years, the investor is eligible for an increase in basis of the QOF investment equal to its fair market value on the date that the QOF investment is sold or exchanged

QUALIFIED OPPORTUNITY ZONES

- If the QOF investment is held for 10 years, there are *no capital gains* dues on the investment
- Unlike in a 1031 exchange where you have to acquire replacement property of equal or greater value and equity, in a QOF, only the gain needs to be reinvested
- 1031 exchange or QOF?
  - Need to look at short and long-term investment objectives

PARTNERSHIP ISSUES

- The technical termination of a partnership if more than 50% of the ownership has changed has been repealed. (Section 708(b)(1)(B))
  - This creates a planning opportunity for partners who want to buy out other partners and preserve their ability to effect a 1031 exchange

UNCERTAINTIES REMAIN

- What happens when immediate expensing starts to phase out in five years?
- Will they need to find a way to pay for immediate expensing if 100% is extended?
- Could the Democrats repeal TCJA?
- Could personal property exchanges be added back to Section 1031 at a future date?
- Could some intangibles be allowed to qualify?

LIVE TO DIE ANOTHER DAY?

- 1031 exchanges remain a target for a variety of reasons:
  - Could be used as a "pay for;" already on shopping list
  - Repeal already included in Camp bill
  - Perceived to be "loophole" for rich despite more than half of real property exchanges involving "mom and pops" exchanging a single family rental
  - If Democrats take control, they will likely open up tax reform again and we could be right back where we started

SUMMARY

- 1031 exchanges remain a powerful wealth accumulation vehicle for business owners and real estate investors
- Personal property exchanges have been repealed but immediate expensing is providing alternative value for most assets
- Uncertainties remain but great strides were made in educating on the importance of 1031 exchanges

QUESTIONS & ANSWERS

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