



Section 1031 Exchanges: Diving Deeper and Spearfishing for More Clients

PRESENTED TO:



DECEMBER 7, 2021

BEFORE WE START



A moment of silence please





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AGENDA

1031 EXCHANGE GENERALLY

- Property Excluded
- Property Included
- Holding Period
- “Like-Kind” Property
- Time Restrictions
- Identification Requirements
- Valid Exchange Expenses
- The Value of 1031 Exchange

DEEPER DIVE

- Related Party Exchanges
- Cash-out Refinancing
- Overcoming Obstacles to Successful Exchanges
- Reverse Exchanges
- Improvement/Construction Exchanges
- Mixed-Use Properties
- Less-Than-Fee Interests
- Replacement Property Alternatives
 - NNN
 - TIC
 - DST
 - Oil & Gas Royalties

REALLY DEEP DIVE

- New Real Property Regulations
- Why 1031 Exchanges are Important to the Economy
- 1031 Exchanges as an Estate Planning Tool
- Spearfishing – How to Build Business and Increase Listings with 1031 Exchanges



1031 EXCHANGE GENERALLY



PROPERTY EXCLUDED



Virtually any business or investment asset:

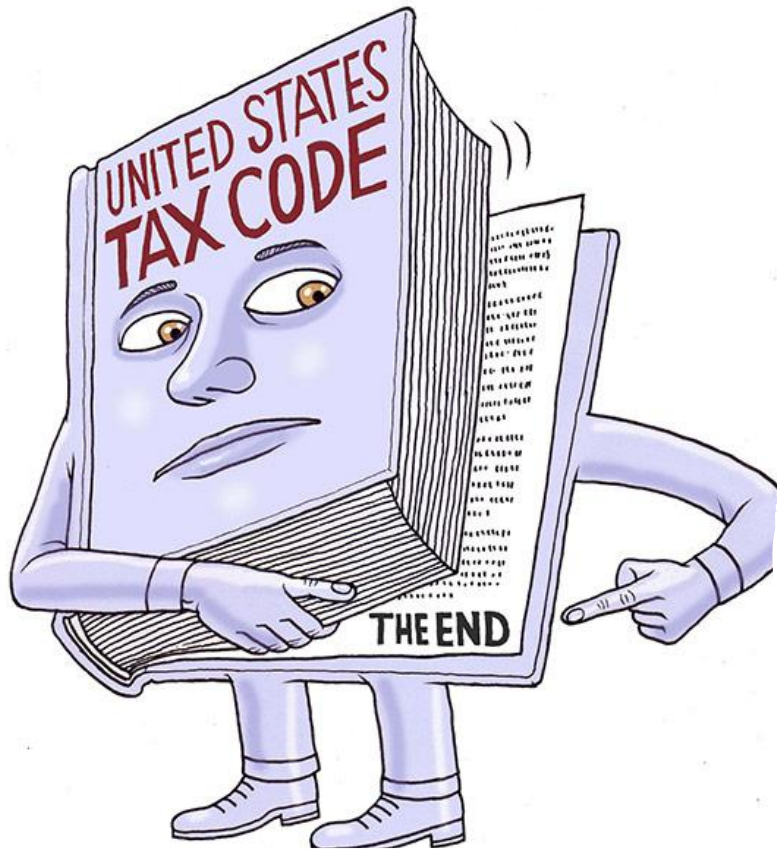
- Agricultural Equipment
- Aircraft
- Artwork
- Boats
- Broadcast Spectrums
- Buses
- Coin Collections
- Construction Equipment
- Distribution Routes
- Equipment
- Fleets of Vehicles
- Franchise Rights
- Livestock
- Patents and other Intellectual
- Precious Collectibles
- Race Cars, Antique Cars
- Race Horses
- Railcars & Locomotives
- And More

*** Tax Cuts and Jobs Act of 2017 limited Section 1031 to real property only.**

ALSO DOES NOT APPLY TO



IRC §1031



Section 1031(a)(1) provides:

“No gain or loss shall be recognized on the exchange of real property held for productive use in or 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 for productive use in a trade or business or for investment.”

Note that Section 1031 provides for deferral of taxes, not complete elimination.

PROPERTY INCLUDED

“real property held for productive use in a trade or business, or for investment”



NOTE: Vacation homes and second homes generally do not qualify



HISTORY OF SECTION 1031

- 1918 – First Income Tax law
- 1921 – Gain or loss not recognized on exchanges of like-kind property (IRC Section 202)
- 1954 – Code section changed to Section 1031
- 1979 – Starker decision; 9th US Circuit Court of Appeals
- 1984 – 45 & 180-day restrictions
- 1991 – Regulations 1.1031 issued
- 1997 – Taxpayer Relief Act; distinction between domestic and foreign property
- 2000 – Rev. Proc. 2000-37 permits “reverse exchanges”
- 2017 – Tax Cut & Jobs Act limits 1031 to real property only



TAXATION 101

- Generally, all income is taxable, unless specifically exempted by law.
- Even illegal income, such as stolen or embezzled funds, must be reported on Line 21 of Form 1040.



WHY EXCHANGE?

Wealth Building

Leverage dollars otherwise spent on taxes

Reallocate Assets

Transfer among residential, commercial, retail, etc.

Relocate Assets

To another town, county, or state

Estate Planning

Diversify and/or reallocate assets to plan for inheritance by heirs

Tax Strategy

Depreciation recapture and capital gains taxes can be substantial



THE VALUE OF 1031 EXCHANGE

Example	
Cost Basis	\$2,000,000
Depreciation Taken	\$512,821 (approx. 10 years)
Sale Price	\$6,500,000

Capital Gain	
Sale	\$6,500,000
Cost Basis	(\$2,000,000)
Depreciation	(\$512,821)
Capital Gain	\$3,987,179

SELLING & BUYING		COMPLETE 1031 EXCHANGE	
Sale Price	\$6,500,000	Sale Price	\$6,500,000
Depreciation Taken	\$512,821	Depreciation Taken	\$512,821
25% Federal	(\$128,205)	Federal Deferred	\$0
3.07% PA	(\$15,744)	3.07% PA	(\$15,744)
Capital Gains	\$3,987,179	Capital Gains	\$3,987,179
20% Federal	(\$797,436)	20% Federal	\$0
3.07% PA	(\$122,406)	3.07% PA	(\$122,406)
3.8% Medicare Surtax	(\$122,805)	3.8% Medicare Surtax	\$0
NET PROCEEDS	\$5,313,404	NET PROCEEDS	\$6,361,850
BUYING POWER		BUYING POWER	
LTV	60%	LTV	60%
Acquisition Value	\$13,283,510	Acquisition Value	\$15,904,625
	W/ 1031 Exchange		\$15,904,625
	No 1031 Exchange		\$13,283,510
	Increased Buying Power		\$2,621,115
	% Increase		20%
	Increased Cash Flow		\$157,267 *Assuming 6% Cash Return

For illustrative purposes only. Consult your tax advisors regarding your specific situation. Example using PA. Varies by state.



LONG-TERM CAPITAL GAINS RATES

Long-term Capital Gains - 2021

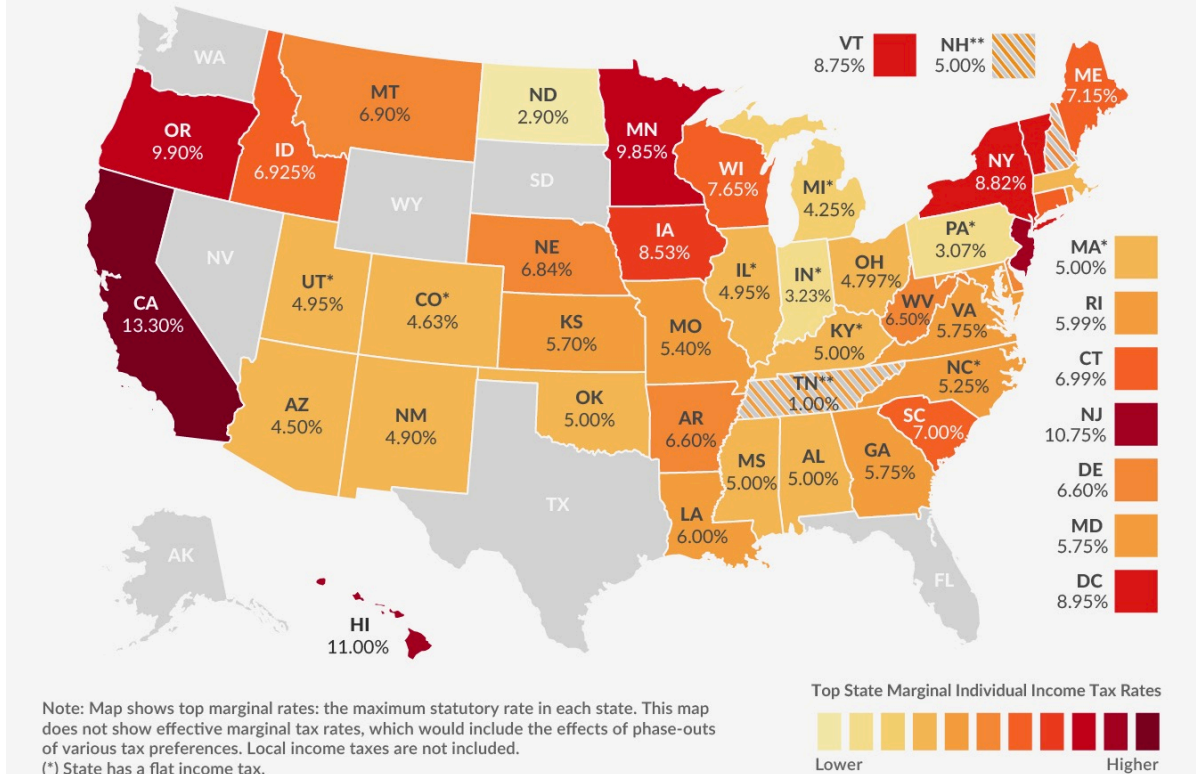
Tax Rate	Single	Married
0%	\$0 - \$40,400	\$0 - \$80,800
15%	\$40,401 - \$445,850	\$80,801 - \$501,600
20%	\$445,851+	\$501,601+



TAX RATES BY STATE – PERCENT

How High are Individual Income Tax Rates in Your State?

Top State Marginal Individual Income Tax Rates, 2020



NJ = #3
 NY = #17
 PA = #41

NJ Fed Medicare Combined 10.75%
 20%
3.8%
 34.55%



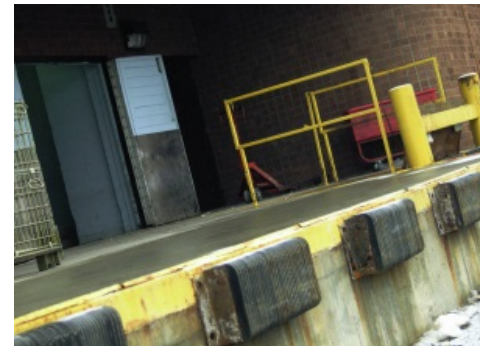
HOLDING PERIOD



LIKE-KIND PROPERTY



Real Property held for productive use in a trade or business, or for investment, may be exchanged for any other real property held for productive use in a trade or business or for investment.



NOTE: domestic property and foreign property are never like-kind.



DELAYED EXCHANGE – TIME LIMITS

- 1984 Congress amends Section 1031
 - 45-day identification period
 - 180-day exchange period runs concurrently
 - Or due date of tax return, whichever is earlier
 - Calendar days, not business days
 - No extensions*
 - Exchange starts on date of recording, or when burdens and benefits of ownership of relinquished property are transferred, whichever is first



IDENTIFICATION REQUIREMENTS

- Signed, and in writing
- Delivered
 - QI or seller of replacement property
- Unambiguously described
 - Legal description
 - Street address
 - Distinguishable name (e.g., Mayfair Apartment Building)
- May be revoked or amended, with same formality as above

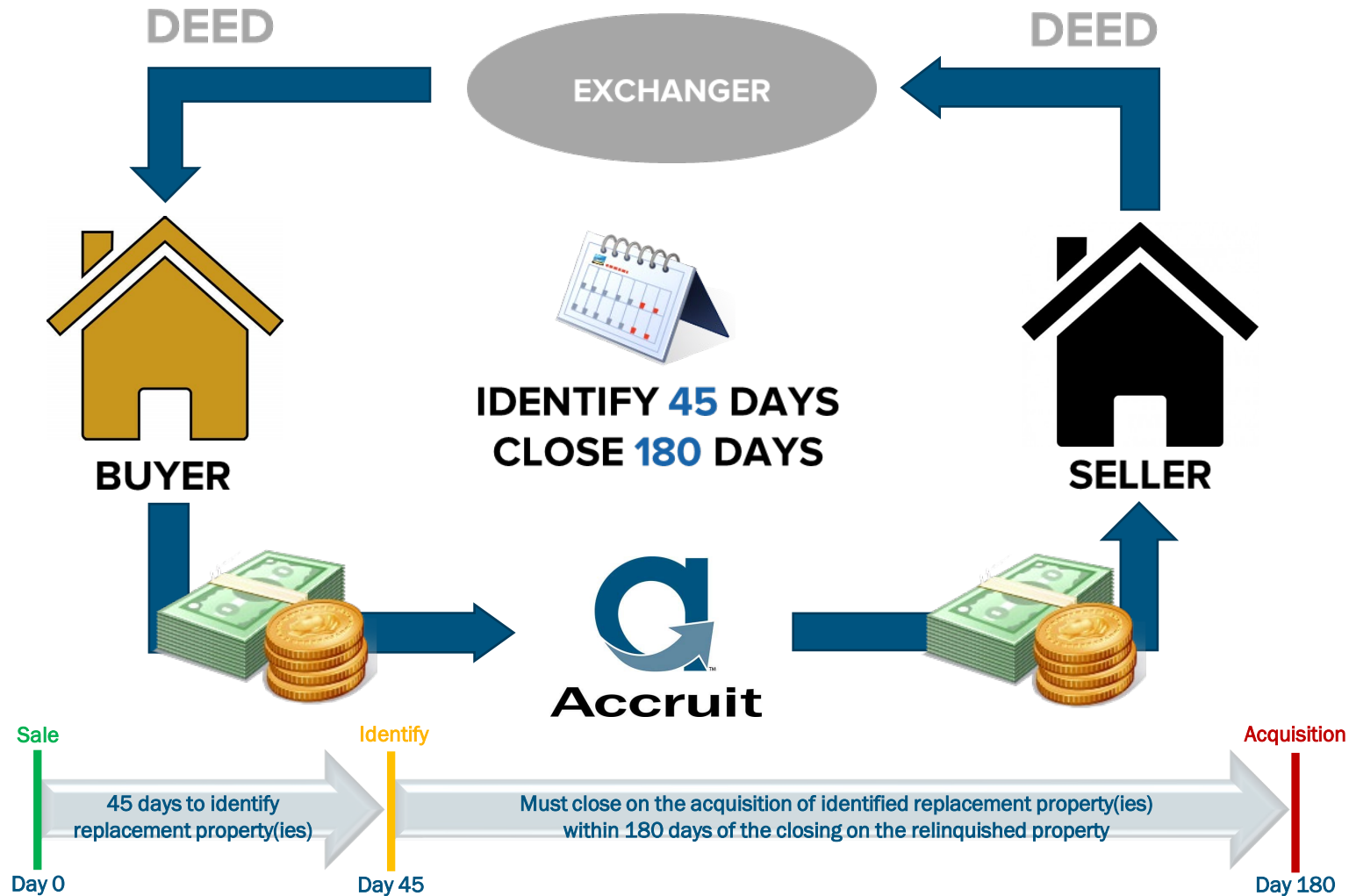


IDENTIFICATION RULES

- **3 Property Rule** – up to 3 properties, without regard to FMV;
or
- **200% Rule** – any number of properties, so long as aggregate FMV does not exceed 200% of FMV of relinquished properties;
but
- **95% Exception** – if first two rules violated, must acquire 95% of FMV of all identified properties

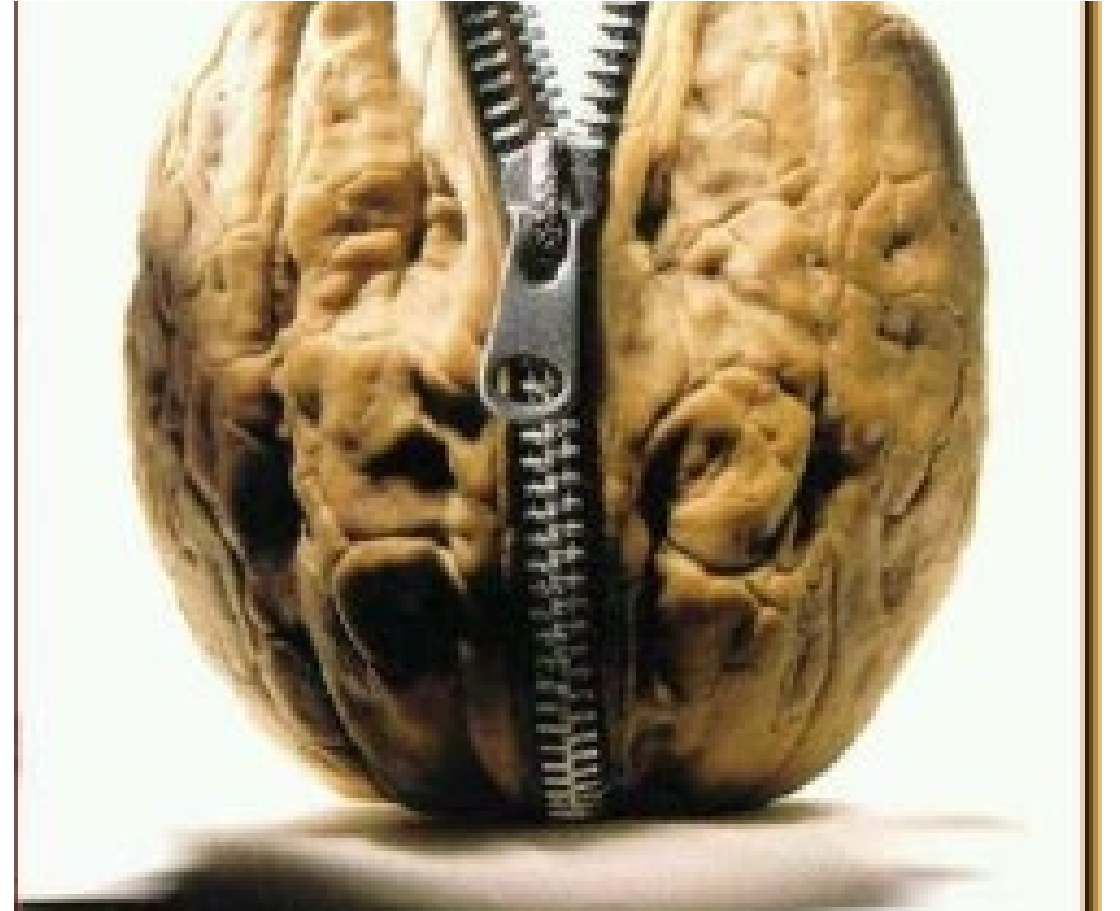


SECTION 1031 EXCHANGE - SIMPLIFIED



SECTION 1031 IN A NUTSHELL

- To obtain complete deferral of capital gains taxes, the taxpayer should:
 - Receive **nothing except like-kind** property
 - Adhere to the 45-day and 180-day time limits
 - Replacement property must be **equal or greater in value** to the relinquished property
 - Must have **equal or greater equity** in the replacement property
 - Must have **equal or greater debt** on the replacement property
 - Taxpayer must avoid **constructive receipt** of exchange proceeds
 - Use a **qualified intermediary (“QI”)**



COOPERATION CLAUSE



Both Parties acknowledge that the other party (the “Exchanging Party”) may exchange the property described on Exhibit “A” in a deferred “Like-Kind Exchange” pursuant to Section 1031 of the Internal Revenue Code of 1986 and the Regulations issued there under. The Non-Exchanging Party shall cooperate with the Exchanging Party in effectuating such exchange at no cost, expense, or liability to the Non-Exchanging Party. The Exchanging Party shall be entitled to assign its rights under this Agreement to a Qualified Intermediary. This assignment shall not relieve the Exchanging Party of its obligations under this Agreement.

EXCHANGE EXPENSES

Allowable closing expenses for IRS 1031 exchange purposes include:

- Real estate broker's commissions, finder or referral fees
- Owner's title insurance premiums
- Closing agent fees (title, escrow or attorney closing fees)
- Attorney or tax advisor fees related to the sale or the purchase of the property
- Recording and filing fees, documentary or transfer tax fees
- Qualified Intermediary fees

Closing expenses which result in a taxable event include:

- Pro-rated rents
- Security deposits
- Utility payments
- Property taxes and insurance
- HOA / Condo Association dues
- Repairs and maintenance costs
- Insurance premiums
- Loan acquisition fees: points, appraisals, mortgage insurance, lenders title insurance, inspections and other loan processing fees and costs – ANY expenses related to a mortgage



A. Settlement Statement (HUD-1)

OMB Approval No. 2522-0255

B. Type of Loan			
1. <input type="checkbox"/> FHA	2. <input type="checkbox"/> VA	3. <input type="checkbox"/> Cono. Ltrns	4. <input type="checkbox"/> Other
5. <input type="checkbox"/> Other	6. File Number	7. Loan Number	8. Mortgage Insurance Case Number
<small>C. Note: This form is furnished to give you a statement of actual settlement costs. Amounts paid to and by the settlement agent are shown. Items marked "to/borrower" were paid outside the closing; they are shown for informational purposes and are not included in the totals.</small>			
D. Name & Address of Borrower:		E. Name & Address of Seller:	
F. Name & Address of Lender:		G. Property Location:	
H. Settlement Agent:		I. Settlement Date:	
J. Place of Settlement:			

B. Summary of Borrower's Transaction		C. Summary of Seller's Transaction	
100 GROSS AMOUNT DUE FROM BORROWER		200 GROSS AMOUNT DUE TO SELLER	
101 Current Sales Price		401 Current Sales Price	
102 Personal Property		402 Personal Property	
103 Settlement Charges to Borrower (Line 1400)		403	
104		404	
105		405	
Adjustments For Items Paid By Seller In Advance		Adjustments For Items Paid By Seller In Advance	
106 City/Town Taxes		406 City/Town Taxes	
107 County Taxes		407 County Taxes	
108 Assessments		408 Assessments	
109		409	
110		410	
111		411	
112		412	
113 Gross Amount Due From Borrower		413 Gross Amount Due To Seller	
200 Amount Paid by or in Benefit of Borrower		300 Reductions In Amount Due To Seller	
201 Deposit Or Earned Money		501 Escrow Deposits (See Instructions)	
202 Principal Amount Of New Loan(s)		502 Settlement Charges to Seller (Line 1400)	
203 Existing Loan(s) Taken Subject To		503 Existing Loan(s) Taken Subject To	
204		504 Payoff of 1st Mortgage Loan	
205		505 Payoff of second Mortgage Loan	
206		506	
207		507	
208		508	
209		509	
Adjustments For Items Unpaid By Seller		Adjustments For Items Unpaid By Seller	
210 City/Town Taxes		510 City/Town Taxes	
211 County Taxes		511 County Taxes	
212 Assessments		512 Assessments	
213		513	
214		514	
215		515	
216		516	
217		517	
218		518	
219		519	
220 Total Paid By/For Borrower		320 Total Reduction Amount Due Seller	
300 Cash At Settlement From/To Borrower		600 Cash At Settlement To/From Seller	
301 Gross Amount Due From Borrower (Line 200)		601 Gross Amount Due To Seller (Line 400)	
302 Loan Amount Paid By/For Borrower (Line 203)		602 Loan Reductions In Amount Due Seller (Line 520)	
303 Cash <input type="checkbox"/> From <input type="checkbox"/> To Borrower		603 Cash <input type="checkbox"/> To <input type="checkbox"/> From Seller	

The Public Reporting Burden for this collection of information is estimated to average 30 minutes per response for collecting, reviewing, and reporting the data. This agency may not collect the information, and you are not required to complete this form, unless it displays a correctly valid OMB control number. No confidentiality is assured; this disclosure is mandatory. This is designed to provide the parties to a HUD-1 covered transaction with information during the settlement process.



DEEPER DIVE



RELATED PARTIES

Rules regarding like-kind exchanges between related parties {§1031(f)} added in 1989/1990

“Related Party” is defined in §267(b) and §707(b). There are about a dozen categories of related parties. Among the more important categories are:

- family (siblings, spouse, parents, children and grandchildren)
- individual and a corporation or a partnership where the same individual owns 50% or more of the ownership of such entity

The rules were established to prevent taxpayers from using §1031 to shift tax basis between related persons:

- Example: A owns property with a basis of \$10 and a FMV of \$100. B, A’s brother, owns property with a basis of \$100 and a FMV of \$10. An unrelated buyer wants to buy A’s property for \$100. If A sells, he would have gain of \$90. If instead A swapped with B and B sold to the buyer, B would have a loss.



RELATED PARTIES

General rule is related parties shouldn't cash out (for at least 2 years)

If there is an exchange of property between related parties and either party, within 2 years, disposes of a property received as part of the like-kind exchange, the non-recognition treatment afforded the original transaction between the related parties will be denied.

The liability accrues as of the date of that transfer, not the original exchange

Certain transfers do not trigger this rule

- transfers occurring after the death of one of the related parties
- transfers of property by involuntary conversion (without prior knowledge of such conversion)
- transfers that do not have tax avoidance as a primary purpose



CASH OUT REFINANCING

- Refinancing Relinquished Property Before Closing
 - Why?
 - Increase Debt/Equity Ratio
 - Access equity for other purposes
 - Others
- Refinancing Replacement Property After Closing
 - Generally, no problem.
 - Timing?



OBSTACLES TO SUCCESSFUL EXCHANGES

- Client uncertainty regarding reinvestment
- Misunderstanding the rules
- Ownership structures
- High debt-to-equity ratio (not enough cash to acquire RP)
- Forgot to contact QI



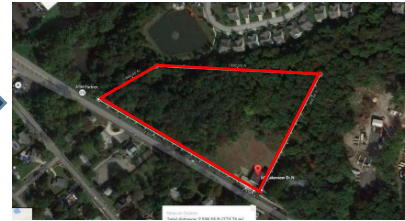
REVERSE EXCHANGES

Typical Transaction

Sell First

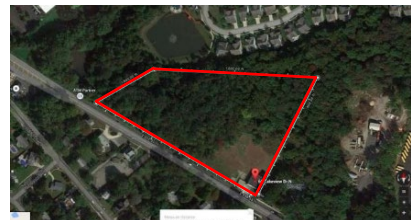


Buy Last



“Reverse” Exchange

Buy First

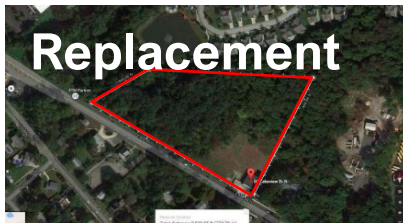


Sell Last



REVERSE EXCHANGES

- Why do a reverse exchange?
 - Seize upon an opportunity
 - Strategic
 - Poor planning – relinquished property isn't selling



- Taxpayer lends \$\$ to Exchange Accommodation Titleholder (“EAT”)
- EAT acquires the replacement property for Taxpayer
- Taxpayer operates property under a Triple-Net Lease (“NNN”) agreement
- Taxpayer takes title when relinquished property sells

- Relinquished property must sell within 180 days
- Property sells, taxes deferred
- Property does not sell, client owns 2 properties

REVERSE EXCHANGE IDENTIFICATION



- Same Rules as Forward Exchange
- 45-day Identification Period
- In Writing
- Signed by Taxpayer
- Delivered to QI
- Three Property Maximum**

CONSTRUCTION / IMPROVEMENT EXCHANGE

- Relinquished property sells
- Proceeds sent to QI
- “EAT” acquires replacement property
- QI holds remaining funds
- QI disburses funds to contractors
- Taxpayer manages construction
- “EAT” transfers completed property to taxpayer



MIXED-USE PROPERTIES

- Some common examples of mixed-use property include:
 - A taxpayer who owns a triplex and lives in one of the units, but rents out the other two units;
 - A taxpayer whose home is on 35 acres, most of which is used as farmland, or for boarding and training horses; or
 - A taxpayer who runs a business out of her home and uses the basement (or other room) of the house for this business purpose.



MULTIPLE PROPERTY EXCHANGE



- Taxpayer can sell multiple properties, to consolidate into fewer properties
- Taxpayer can sell one property to diversify into many properties
- Identification period – all replacement properties must be identified within 45 days of transfer of first relinquished property
- Exchange period – all replacement properties must be acquired within 180 days of transfer of first relinquished property

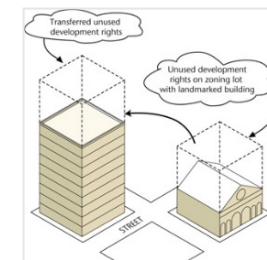
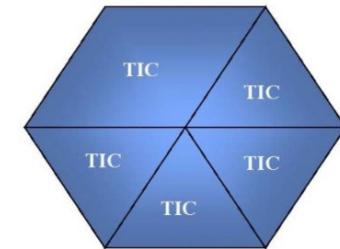
LESS THAN FEE INTERESTS THAT QUALIFY

- Leases with at least 30 years remaining, including renewal options
- Vendee's interest in a land sale contract; not the vendor's interest
- Undivided interest in one property for an undivided or 100% interest in another property
- Remainder interest in real property
- Timber rights, riparian rights, mineral rights, royalties



COMMON LESS-THAN-FEE EXCHANGES

- Timber Rights
- Mining
- Oil
- Riparian Rights
- Tenants in Common
- Transferrable Development Rights
- Others



§1031 EXIT STRATEGY – NNN

- “NNN” or Triple-Net means that the tenant pays for maintenance, taxes and insurance, rather than the landlord.
- Investor typically owns 100% of a property, frequently with a national credit tenant (i.e., Walgreens).
- Usually single tenant.
- Often purpose-built property.



NNN – PROS & CONS

- Hands-free management
 - Tenant typically responsible for all (or nearly all) maintenance, taxes, insurance, etc.
 - Rent received is “net” of those costs.



- Risks include
 - Lack of diversification.
 - Tenant bankruptcy.
 - Store closures.



§1031 EXIT STRATEGY – TIC

- Co-ownership, but must be structured to avoid being considered a partnership.
- Rev Proc 2002-22 provides guidance; 15 factors to be considered.
 - Must hold title to the property as a tenant in common, under local law.
 - Pro-rata rights, responsibilities – profits, losses, proceeds, liabilities.



Office ≈ 51%



Multifamily ≈ 21%



Retail ≈ 16%

TIC – PROS & CONS

- Generally, institutional grade property.
- Pro-rata voting rights.



- Limited to 35 investors.
- Typically, one property per deal.
- Generally, require unanimous approval for changes, etc.
- Might not be bankruptcy remote.

§1031 EXIT STRATEGY – DST

- Under IRS Rev. Ruling 2004-86, a beneficial interest in a Delaware Statutory Trust (“DST”), which holds title to the replacement property, can be considered “like-kind” replacement property for a §1031 exchange.
- Rights and obligations of investors governed by DST’s Trust Agreement. DST investors generally have liability protection (non-recourse loans to the DST, rather than the investors), with limited voting rights over the operation and ownership of the properties.
- DSTs are generally, multi-owner (pro-rata investment), multi-property offerings (i.e., ABC Texas Medical Portfolio DST).



DST – PROS & CONS

- No limit on the number of investors.
- Often own multiple properties.
 - Typically structured on a theme. (i.e., Texas Medical Portfolio DST).
 - May be diversified on geography, asset class, etc.
- Generally, bankruptcy remote.



- No voting rights.
- A portfolio DST counts as multiple properties for identification purposes

OIL & GAS ROYALTIES

- Under Revenue Ruling 55-526, a royalty interest for oil and gas in place constitutes real property for federal income tax purposes
- An overriding royalty interest in minerals exchanged for a city lot qualified for like-kind exchange treatment. *Comm. V. Crichton*, 122 F3d 181 (5th Cir. 1941).
 - “provides guidelines for requesting advance rulings ... [and is] not intended to be substantive rules...”
 - 15 Conditions:
 - Must hold title to the property as tenants in common, as defined by local law
 - Pro-rata rights, responsibilities – profits, losses, proceeds, liabilities



Note: Oil/gas wells 37 states. (1-Texas; 2-Kansas; 3-Oklahoma; 4-Pennsylvania; 14-New York)

OIL & GAS ROYALTIES – PROS & CONS

- DO NOT invest in capital equipment or field operations
- DO NOT get billed for exploration, drilling, or operations costs
- DO NOT share any of the risks or liabilities associated with exploration



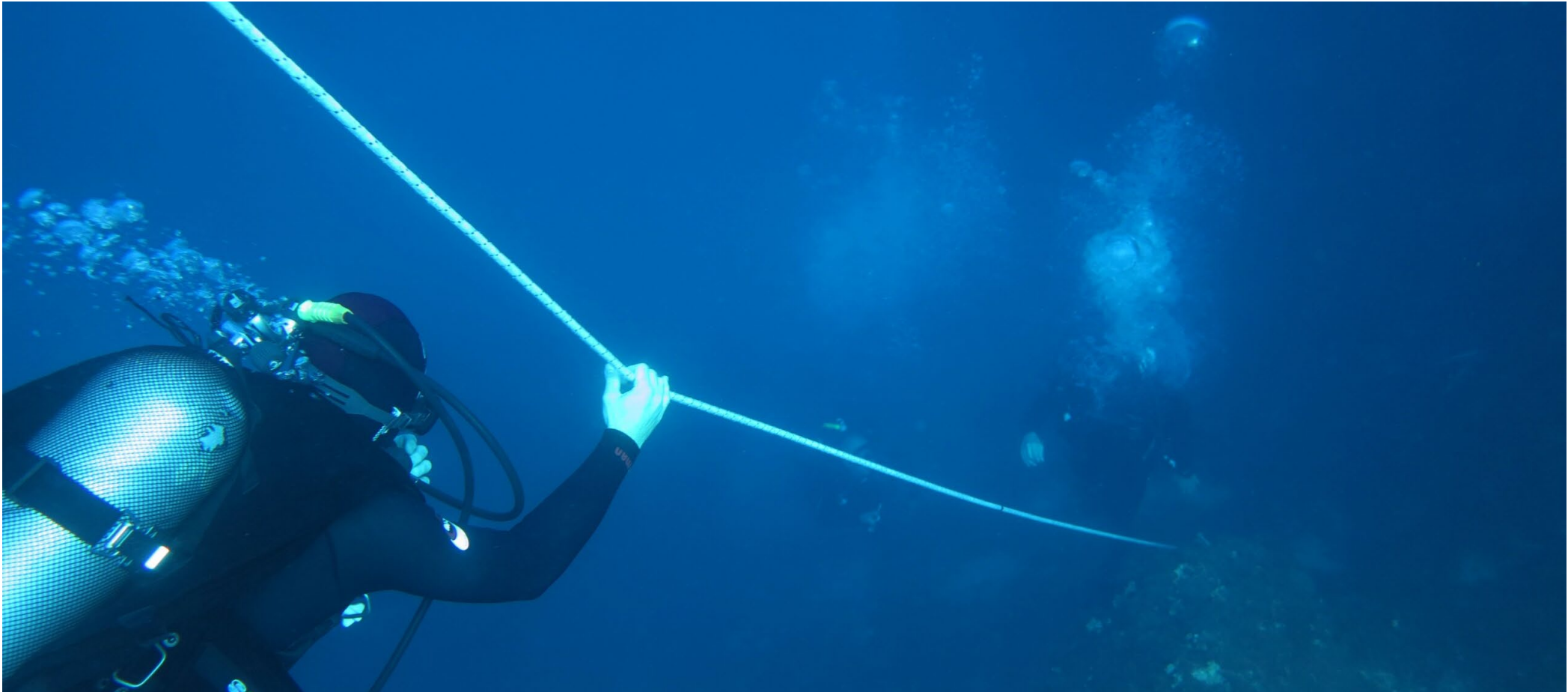
- No payout until the resources are developed, produced and sold
- Physical resources may deplete over time, resulting in declining asset value

§1031 EXCHANGE BITS & PIECES

- Vacation and second homes “may” qualify for exchange, if certain conditions are met. NOT AN EASY TASK.
- Investors may take some cash proceeds from the sale before the funds are sent to the QI. This will result in a taxable event (“boot”) to the investor to the extent that the proceeds were not reinvested. It does not completely taint the exchange.
- Upon the death of the taxpayer, under current tax laws, the heirs would get a “step up” in basis, thereby avoiding all capital gains taxes on the original and subsequent properties. This may be an estate planning strategy for an investor.



REALLY DEEP DIVE



NEW REAL PROPERTY REGULATIONS



- Previously, “real property” was defined solely by state law
- Regulations issued November 18, 2020
 - Remember, TCJA limits 1031 to “real property”
 - Property is “Real Property” if for 1031 purposes if:
 - it is real property under the law of the state or local jurisdiction in which it is located,
 - It is specifically listed as real property in the final regulations, or
 - It is considered real property based on all the facts and circumstances under various factors provided in the final regulations
- Real property consists of land and improvements
 - What about:
 - Large back-up generator next to the building?
 - Large, immovable machine used in the business operations conducted there?
 - Bottom line: Important for taxpayer to consult their tax/legal advisors.



WHY 1031 EXCHANGES ARE IMPORTANT

- Like-kind exchanges stimulate business growth
 - Like-kind exchanges stimulate needed capital investment
 - Like-kind exchanges help repurpose available real estate
 - Like-kind exchanges create jobs
 - Like-kind exchanges help family farmers
 - Taxes are deferred, not eliminated
-
- Visit www.1031buildsameric.org for more information



1031 EXCHANGES AS AN ESTATE PLANNING TOOL



- Typical sale results in capital gains and other taxes.
- Holding until death results in “stepped up basis”
- Example:
 - Grandpa owns a highly appreciated shopping center
 - Grandpa has four grandchildren
 - Grandpa uses §1031 to replace the shopping center with:
 - TIC or DST property
 - Hard assets near the grandchildren
 - Etc.

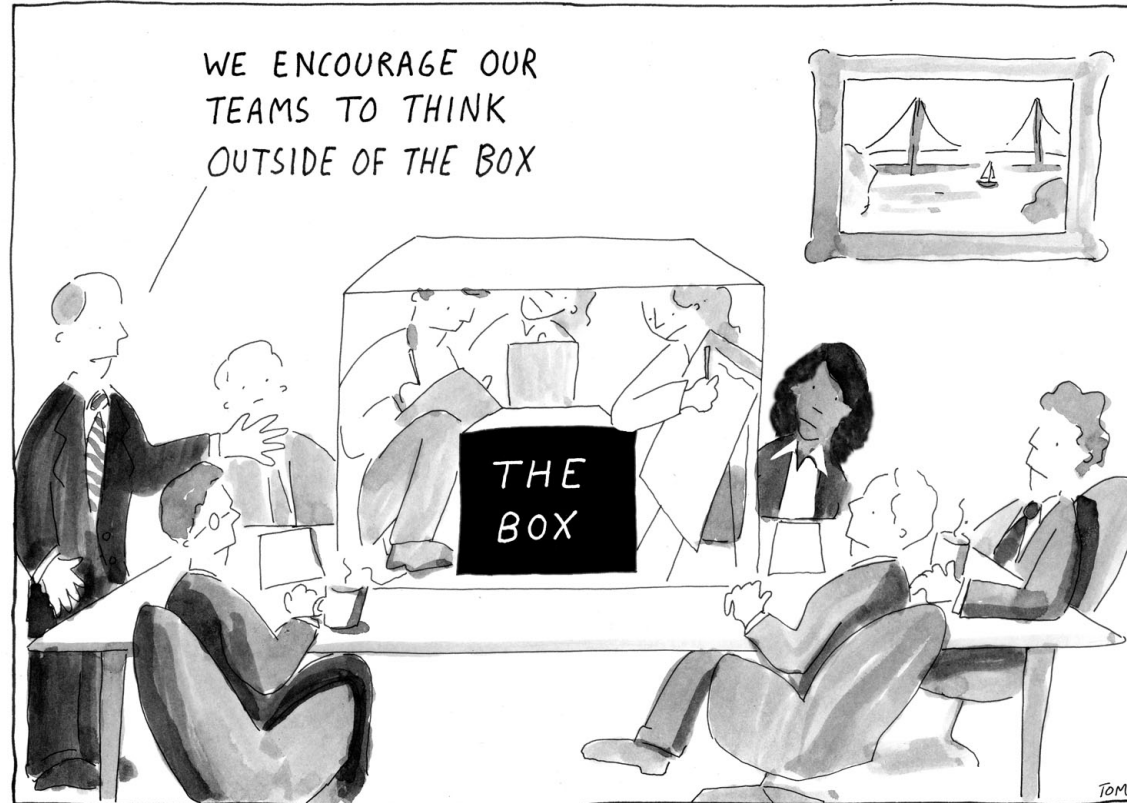
SPEARFISHING – HOW TO BUILD BUSINESS AND INCREASE LISTING WITH 1031 EXCHANGES



GETTING STARTED

BRAND CAMP

by Tom Fishburne



© 4/19/04

SKYDECKCARTOONS.COM



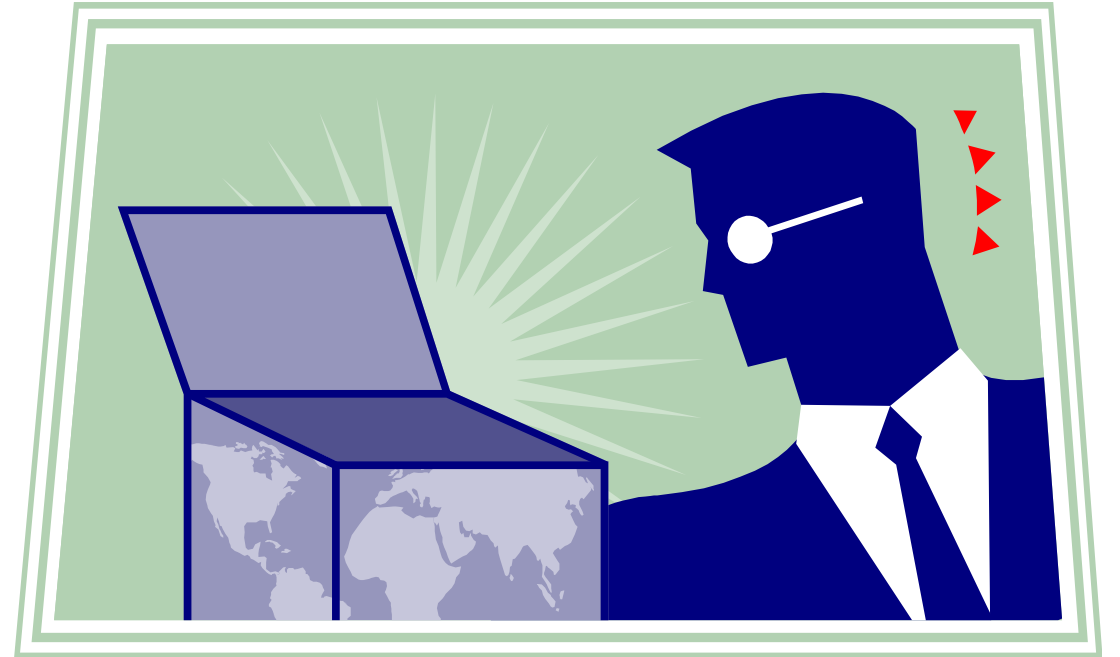
UNCOVERING HIDDEN LISTINGS

- Typical listings
 - Homeowners relocating
 - “Upsizing”
 - McMansions?
 - “Downsizing”
 - Empty nesters, etc.
- Atypical listings?
 - What are they? Where are they?



STEP ONE

- Forget the box!



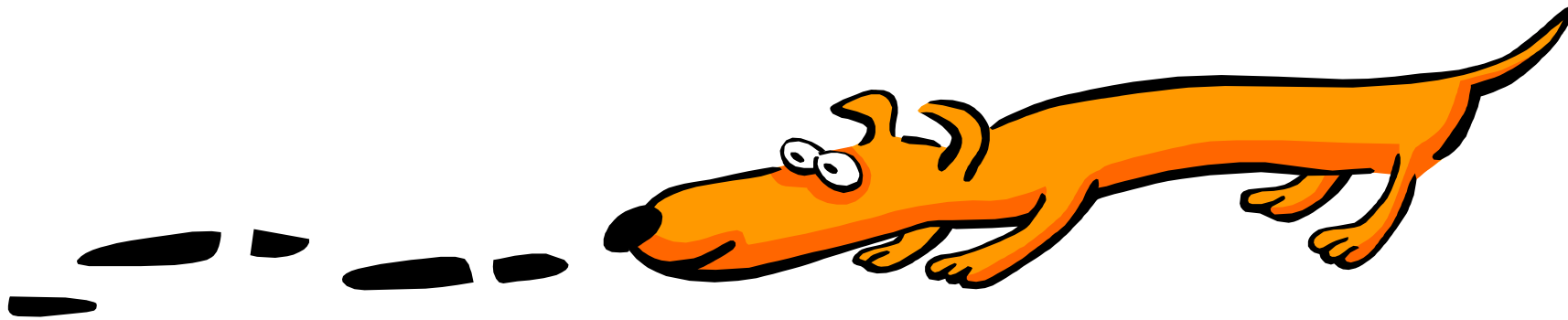
STEP TWO



- Positioning

STEP THREE

- Finding the investors



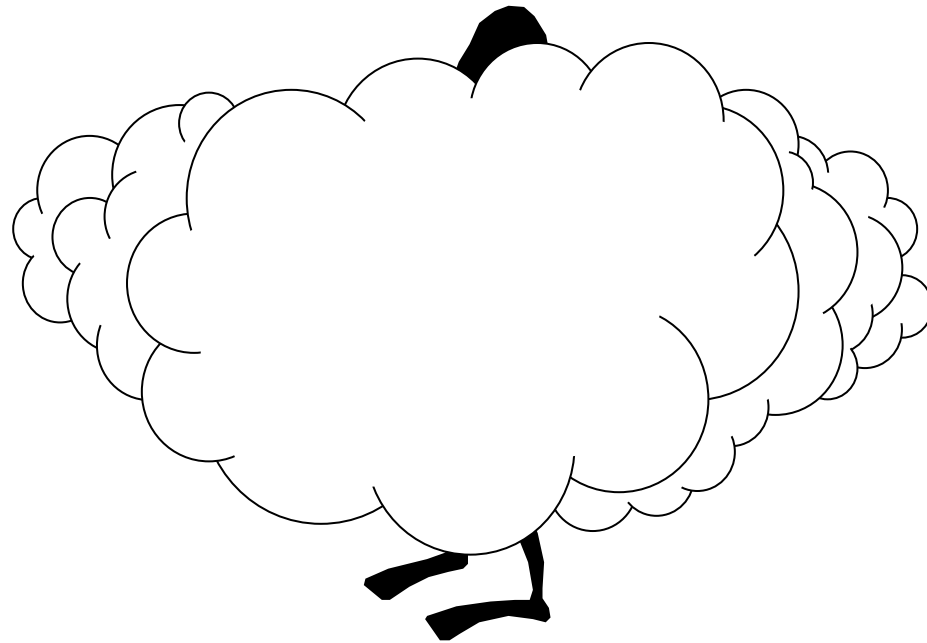
STEP FOUR

- Fishing



STEP FIVE

- Approaching the investors



STEP SIX

- Investor education



STEP SEVEN

- Regular updates



HOW YOU HELPED THEM?

- Taxes!
- Better investments
- Estate planning
- Etc.



- Their CPA probably never told them about this!

HOW THEY WILL HELP YOU!

- Referrals
 - Quantity
 - Quality
- Loyalty
- Value



CONTACT INFORMATION



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