§1031
Zoom Webinar on May 13, 2023

Presented by
Tom Gorczynski, EA USTCP

Goal for today's webinar

Discuss §1031 concepts and how it's been tested on the Tax Court exam

Today's Learning Objectives

- Explain how recently released final regulations define real property for §1031 purposes.
- Describe how a real estate transaction qualifies for §1031 treatment.
- Calculate the tax results of a typical §1031 exchange to the taxpayer.

§1031 Overview

§1031 is a nonrecognition provision as it allows a taxpayer who realizes a gain from the exchange of certain types of property to not recognize that gain for federal tax purposes.

The nonrecognition of gain occurs by generally transferring the basis in the existing property to the new property, with adjustments.

§1031 Overview

1. What is the *gain realized* in the transaction?

- Amount realized, less
- Adjusted basis (of property given up).

The amount realized is the amount received less any expenses of sale.

§1031 Overview

2. Does the transaction qualify for §1031?

- Is it an exchange?
- Is it real property?
- Is the property like-kind?
- Is the property held by the taxpayer for the productive use in a trade or business or for investment?

If no to any of these questions, then the taxpayer fully recognizes the gain realized.

§1031 Overview

3. Did the taxpayer receive money or other property (boot) in the exchange?

- If yes, the taxpayer recognizes gain equal to the lesser of
  - The fair market value (FMV) of boot received, or
  - The gain realized in the exchange.
- The taxpayer does not recognize loss even if the taxpayer receives boot in the exchange.

§1031 Overview

4. What is the taxpayer's basis and holding period in the property received in the exchange?

- There is a transferred basis from the relinquished property to the replacement property.
- If the property has a transferred basis, it also has a "tacked" holding period.
- Shortcut: the taxpayer's basis in the replacement property is the FMV of the replacement property:
  - Less gain deferred in the exchange, or
  - Plus loss deferred in the exchange.

§1031 Overview

In the year a §1031 exchange occurs, the taxpayer must file Form 8824, *Like-Kind Exchanges*, with the tax return.

A taxpayer must also file Form 8824 in each of the two years following the year of a related-party exchange.

§1031 Overview

Example 1. In 2016, Quinn purchases a parcel of land for investment purposes for $100,000.

In 2020, Quinn's parcel of land is worth $150,000. He exchanges his parcel of land for Bob's parcel of land in another county, also worth $150,000. He intends to hold the land for investment purposes.

§1031 Overview

Example 1 (continued). Quinn's gain realized is $50,000:
- $150,000 amount realized (FMV of Bob's land), less
- $100,000 adjusted basis in his original land parcel.

If §1031 applies, Quinn's gain recognized is $0.

Quinn's basis in the land is $100,000, which is his basis in the original property. It is also the $150,000 FMV of the replacement property less the $50,000 gain deferred.

§1031: Exchange

An exchange is a reciprocal transfer of property, as distinguished from a transfer of property for a money consideration only.

A sale of property followed by a reinvestment in like-kind property does not qualify for §1031 deferral.

This determination is made on the substance of the transaction, not its form.

§1031: Exchange

A like-kind exchange does not have to be simultaneous (and, in fact, rarely is).

In *Starker*, the Ninth Circuit held that a taxpayer's transfer of real property in exchange for a promise to transfer real property, or cash to the extent real property not transferred, within five years qualified for §1031 deferral.

§1031: Exchange

Congress later put time limits on deferred exchanges:

- The taxpayer must identify the replacement property within 45 days after the date the taxpayer transfers the relinquished property, and
- The taxpayer must receive the replacement property no later than the earlier of:
  - 180 days after the transfer of the relinquished property, or
  - The due date of the transferor's tax return (plus extensions) for the tax year containing the transfer of the relinquished property.

§1031: Exchange

The regulations provide for four safe harbors, the use of one or more of which will result in the determination that the taxpayer is not in actual or constructive receipt of the exchange proceeds:

- Security or guarantee arrangements,
- Qualified escrow accounts,
- Qualified trusts, or
- Qualified intermediaries.

§1031: Exchange

A qualified intermediary enters into a written agreement with the taxpayer and does the following:

- Acquires the relinquished property from the taxpayer,
- Transfers the relinquished property,
- Acquires the replacement property, and
- Transfers the replacement property to the taxpayer.

§1031: Like-Kind

Regulations state the following regarding whether property is like-kind:

- "... the words *like kind* have reference to the nature or character of the property and not to its grade or quality."
- "The fact that any real estate involved is improved or unimproved is not material, for that relates only to the grade or quality..."

§1031: Like-Kind

In *Crichton,* the Court held the exchange of an improved city lot for mineral interests from unimproved country land was like-kind.

"...No gain or loss is realized by one, other than a dealer, from an exchange of real estate for other real estate... it was not intended to draw any distinction between parcels of real property however dissimilar they may be in location, in attributes and in capacities for profitable use."

§1031: Like-Kind

The following do not qualify for §1031 deferral:

- Real property held primarily for sale,
- Partnership interests unless §761 election out of Subchapter K election made, and
- Real property in the U.S. exchanged for real property located outside the U.S.

§1031: Real Property

In November 2020, the IRS issued final regulations defining real property for §1031 purposes as:

- Land and improvements to land,
- Unsevered natural products of land,
- Water and air space superjacent to land,
- Certain intangible interests in real property, and
- Property that is real property under state or local law.

§1031: Real Property

Example 2. Are the following real property for §1031 purposes?

- Perennial fruit-bearing plants:
  - Plants themselves – YES
  - Harvested fruit – NO
- Marina comprised of boat slips and end ties:
  - Boat slips – YES
  - End ties – YES

§1031: Real Property

Example 2 (continued).

- Indoor sculpture weighing 5 tons – YES
- Moveable, pre-fabricated bus shelters – NO
- Industrial 3D printer and generator – YES
- Water pipeline if real property under state law – YES
- Special use permit to place a cell tower on Federal Government land – YES
- License to operate a casino – NO

§1031: Business/Investment Use

To qualify for §1031, the taxpayer must, at the time of the exchange, intend to hold the property for productive use in a trade or business or for investment.

Property held for productive use in a trade or business may be exchanged for property held for investment.

Property held for investment may be exchanged for property held for productive use in a trade or business.

§1031: Business/Investment Use

In *Bolker*, the Court summarized the rule at issue here:

"...if a taxpayer owns property which he does not intend to liquidate or to use for personal pursuits, he is 'holding' the property 'for productive use in a trade or business or for investment' within the meaning of §1031(a)."

§1031: Boot Received

In a §1031 exchange, boot receives includes the following received by the taxpayer:

- Money,
- Other property, and
- Net debt relief.

The assumption of debt by another taxpayer or the acquisition of debt from another taxpayer are treated as money received or given in the transaction.

§1031: Boot Received

In a transaction in which the taxpayer both gives up and acquires debt, the taxpayer nets the amounts together to determine if there is net debt relief.

Consideration given as money or other property is offset against consideration received as net debt relief.

Consideration received as money or other property is not offset against consideration given as net debt relief.

§1031: Basis and Holding Period

If a taxpayer engages in a §1031 exchange, then the basis of the property received is equal to:

- Adjusted basis of the original property
- PLUS gain recognized in the exchange,
- LESS loss recognized in the exchange,
- LESS amount of money received in the exchange.

The net effect is the taxpayer's new basis is the FMV of the replacement property reduced by the gain deferred or increased by the loss deferred.

§1031: Basis and Holding Period

If the taxpayer receives boot in the exchange, the taxpayer allocates total basis among the properties based on their FMV, with the boot's basis set at FMV as of the date of the exchange.

The taxpayer has a "tacked" holding period if the replacement property has, in whole or in part, a transferred basis from relinquished property that was a capital asset or §1231 property in the hands of the transferor.

Related Party Exchanges

§1031 deferral does not apply if a taxpayer exchanges property with a related person (described in §267(b) and §707(b)(1)) and within two years of the last transfer either the taxpayer disposes of the replacement property, or the related person disposes of the relinquished property.

Gain or loss is recognized in the tax year in which the disposition occurs.

§1031: Comprehensive Example 1

Nick exchanges land with an adjusted basis of $29,500 for land with a FMV of $20,000 and $10,000 in cash.

Nick paid a $2,000 commission to a real estate broker.

The land parcels are both like-kind and Nick held the original parcel for investment and intends to hold the replacement parcel for investment.

§1031: Comprehensive Example 1

1. Nick's loss realized is $1,500:

$20,000	FMV of land received
$10,000	Cash received
$30,000	Amount received
($2,000)	Brokerage commission
$28,000	Amount realized
($29,500)	Adjusted basis of land given up
($1,500)	Loss realized

§1031: Comprehensive Example 1

2. The exchange qualifies for §1031 treatment:

- There is an exchange.
- Both properties are real property.
- The properties are like-kind.
- Both properties were held by the taxpayer for the productive use in a trade or business or for investment.

§1031: Comprehensive Example 1

3. Nick received $10,000 in boot in the transaction.

However, because there is a loss realized, Nick does not recognize any of the loss in the exchange.

§1031: Comprehensive Example 1

4. Nick's basis in the new parcel of land is $21,500:

$29,500	Adjusted basis of land given up
($10,000)	Cash received
$2,000	Brokerage commission
$21,500	Adjusted basis in replacement land

Note that $21,500 is the same as the $20,000 FMV of the replacement land plus the $1,500 loss deferred.

§1031: Comprehensive Example 2

David owns an apartment house. On December 1, 2021, it has an adjusted basis of $100,000, a FMV of $220,000, and is subject to a mortgage of $80,000.

Elena also owns an apartment house. On December 1, 2021, it has an adjusted basis of $175,000, a FMV of $250,000, and is subject to a mortgage of $150,000.

§1031: Comprehensive Example 2

On December 1, 2021, David transfers his apartment house to Elena, and he receives Elena's apartment house plus $40,000 cash. Each apartment house is transferred subject to the mortgage on it.

David receives $140,000 of value in the exchange ($100,000 apartment house equity plus $40,000 cash).

Elena receives $140,000 of value in the exchange ($140,000 apartment house equity).

§1031: Comprehensive Example 2

1. David's gain realized is $120,000:

$250,000	FMV of property received
$40,000	Cash received
$80,000	Mortgage given up
$370,000	Amount realized
($100,000)	Adjusted basis of property given up
($150,000)	Liabilities to which new property subject
$120,000	Gain realized

§1031: Comprehensive Example 2

2. The exchange qualifies for §1031 treatment:

- There is an exchange.
- Both properties are real property.
- The properties are like-kind.
- Both properties were held by the taxpayer for the productive use in a trade or business or for investment.

§1031: Comprehensive Example 2

3. David received $40,000 in boot in the transaction.

The $40,000 is the cash received in the transaction.

David has a net debt assumption; therefore, there is no boot from the debt transactions. The net assumption of liabilities does not offset the cash received in the transaction.

§1031: Comprehensive Example 2

4. David's basis in the new apartment house is $170,000:

$100,000	Adjusted basis of property given up
$150,000	Liabilities received
$40,000	Gain recognized upon exchange
($40,000)	Cash received
($80,000)	Liabilities transferred
$170,000	Adjusted basis in new apartment house

Note that $170,000 is the same as the $250,000 FMV of the replacement property less the $80,000 gain deferred.

§1031: Comprehensive Example 2

1. Elena's gain realized is $75,000:

$220,000	FMV of property received
$150,000	Mortgage given up
$370,000	Amount realized
($175,000)	Adjusted basis of property given up
($80,000)	Liabilities to which new property subject
($40,000)	Cash paid
$75,000	Gain realized

§1031: Comprehensive Example 2

2. The exchange qualifies for §1031 treatment:

- There is an exchange.
- Both properties are real property.
- The properties are like-kind.
- Both properties were held by the taxpayer for the productive use in a trade or business or for investment.

§1031: Comprehensive Example 2

3. Elena received $30,000 in boot in the transaction.

$150,000	Liabilities transferred
($80,000)	Liabilities received
($40,000)	Cash paid
$30,000	Boot received

The net debt relief can be offset by money or other property given as consideration in the transaction.

§1031: Comprehensive Example 2

4. Elena's basis in the new apartment house is $175,000:

$175,000	Adjusted basis of property given up
$80,000	Liabilities received
$30,000	Gain recognized upon exchange
$40,000	Cash paid
($150,000)	Liabilities transferred
$175,000	Adjusted basis in new apartment house

Note that $175,000 is the same as the $220,000 FMV of the replacement property less the $45,000 gain deferred.

2021/S-10

TP and B exchange unimproved real properties that are encumbered by mortgage debts. In the exchange transaction, TP's mortgage debts are assumed by B, and B's mortgage debts are assumed by TP. The gross fair market value of B's property is $200,000, its adjusted basis is $120,000, and it is encumbered by a $50,000 mortgage debt leaving a net equity of $150,000. The gross fair market value of TP's property is $220,000, its adjusted basis is $200,000, and it is encumbered by a $70,000 mortgage debt leaving a net equity of $150,000. Discuss and quantify the § 1031 consequences to TP (not B).

2021/S-10

TP's property:		B's property:	
$220,000	FMV	$200,000	FMV
($70,000)	Mortgage value	($50,000)	Mortgage value
$150,000	Equity	$150,000	Equity
$200,000	Adjusted basis	$120,000	Adjusted basis

TP has a gain realized of $20,000 ($200k FMV plus $20k debt relief less $200k AB).

TP has a gain recognized of $20,000 (to the extent of boot, or $20k net debt relief).

TP's new basis is $200,000 ($200k AB plus $20k gain recognized less $20k net debt relief).

TP's new basis is unchanged because there is no gain or loss deferral.

Questions & Answers

Let's take as many as we can

You CAN do this!!
And we can help …

Working together for success on the Tax Court exam