TWENTY THINGS REAL ESTATE ATTORNEYS CAN DO TO NOT MESS UP A SECTION 1031 EXCHANGE

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This article was initially conceived for The Practical Real Estate Lawyer's sibling publication, The Practical Tax Lawyer. Part 1 of the version that appeared earlier in The Practical Tax Lawyer covered items 1 through 10 of this list and focused on the issues that arise as property owners begin contemplating an exchange, matters to consider when selecting a QI, and events to plan for as an exchange gets started and the end of the 45-day identification period approaches.[1] This version of the article considers complex transactions and matters that real estate attorneys should keep in mind as they work with their clients to ensure that exchanges progress smoothly and wrap up according to the exchangers' desired tax goals.

Since the manuscript for the version that appeared as Part 1 in The Practical Tax Lawyer was submitted, much has happened in the section 1031 space. Adjustments related to COVID-19 have stalled many section 1031 exchanges. The IRS provided guidance that extends 45-day identification periods and 180-day exchange periods that would otherwise have expired between April 1 and July 15. That guidance brought relief to some exchangers, but the industry generally hoped that the IRS would have done more.[2] As of the writing of this article, the IRS has yet to issue additional guidance, but it indicated that it would.[3] That guidance, if sufficiently generous, will help exchangers better navigate the economic fallout of COVID-19. Many exchanges that stalled will eventually move forward (sooner with the help of generous IRS guidance), and, as the exchange industry returns to capacity, the items discussed in this article will be important to remember.

1. Notify your client if property being sold could qualify for section 1031 treatment

Section 1031 applies to real property held for use in a trade or business or for investment. If the real estate deal that you are working on involves business-use or investment real property, the property may qualify for section 1031 treatment, so let your client know about section 1031. It is not uncommon for a seller to show up at closing, learn that the buyer is acquiring the property to complete a section 1031 exchange, and realize that section 1031 might help the seller defer gain. Although the seller may be able to alter course that late in the transaction and still structure the sale as part of a section 1031 exchange, that last-minute rush makes it difficult for parties to review exchange documents and make sure everything is in order for the closing.

Real estate attorneys should let their clients know about section 1031 well before they get to the closing table. Property held primarily for sale and property held exclusively for personal use does not qualify for section 1031 treatment. Real estate attorneys should let their clients know that any other type of real property might qualify for a section 1031 exchange. To be safe, real estate attorneys should suggest that their clients consult tax experts to assess the viability of doing a section 1031 exchange of any property if there is a chance that their clients will reinvest the proceeds in other real property. It would be a shame for a property owner to sell property, pay tax, and reinvest the remaining exchange proceeds in property that would have satisfied section 1031. Such lost opportunities can be costly, and clients should have a say in the decision to do or not do a section 1031 exchange.

2. Remember that reverse exchanges may be an option

If your client is buying property and may be selling property soon, let your client know that a reverse exchange may be worth considering. Reverse exchanges generally are structured as title-parking exchanges. With such transactions, an accommodator takes title to one of the exchange properties—typically the replacement property, but can be the relinquished property—and holds that title until the exchanger sells the relinquished property. The exchanger uses proceeds from the sale of the relinquished property to acquire the replacement property from the accommodator. The IRS has created a safe harbor for reverse exchanges that can be completed within 180 days. That safe harbor provides significant latitude in structuring the management, financing, and use of the parked property allowing the exchanger to take control of the parked property without becoming the tax owner of it. In Estate of Bartell v. Commissioner, the U.S. Tax Court granted section 1031 nonrecognition to an exchange of property that was parked with the accommodator for more than a year, so these transactions can be structured outside the confines of a safe harbor. Reverse exchanges are form-driven, so adhere closely to the safe harbor or case law.

3. Leasehold improvements are great for the right circumstances

Exchange proceeds can also be used to construct improvements on property the exchanger does not own but will acquire. If an exchanger wants to use exchange proceeds to acquire property and construct improvements on it, the exchanger may consider setting up a title-parking arrangement and have an accommodator acquire the target property and construct the improvements. If the exchanger can complete the improvements within 180 days after the accommodator takes title to the property, then the transaction can be completed within the title-parking safe harbor. Otherwise, the Tax Court's decision in Bartell will provides guidance for structuring the transaction.

If an exchanger wants to use exchange proceeds to construct improvements on property owned by a party related to the exchanger, consider recommending a leasehold improvements exchange. With such exchanges, the related party enters into a long-term ground lease with the accommodator. While the accommodator holds the leasehold, the exchanger directs construction of the improvements. The exchanger then uses the exchange proceeds to acquire the leasehold interest from the accommodator. If the leasehold has at least 30 years to run, then it and the improvements should be valid replacement property. The related-party rules should not be a problem with this type of transaction because the ground lease calls for fair market rent of the land, which the accommodator and then the exchanger will pay. The related party will recognize ordinary income on the receipt of those rental payments. The value of the leasehold to the exchanger will be in the improvements. These types of transactions allow exchangers to reinvest large amounts of exchange proceeds into the replacement property improvements. Because exchangers control the parked property on which the improvements will be built and can control the readiness of the property, they can control the amount that is invested in the 180-day parking period. Thus, the property can be under construction or shovel-ready when the accommodator enters into the lease with the related party, and construction can commence apace, consuming large quantities of exchange proceeds in a relatively short period of time.

4. Understand the (g)(6) restrictions and explain them to your client

QIs exist to ensure that exchangers are not in actual or constructive receipt of exchange proceeds. To provide that benefit, a QI's exchange documents must include the (g)(6) restrictions. The (g)(6) restrictions provide that the exchanger shall not "receive, pledge, borrow, or otherwise obtain the benefit of" the exchange proceeds before the end of the 45-day identification period or exchange period, as appropriate. If the exchanger does not identify any property during the identification period, then the (g)(6) restrictions lapse at the end of the identification period. If the exchanger does not identify any replacement property, the exchanger can receive the exchange proceeds after the 45th day and the sale will be taxable.

If the exchanger has property identified at the end of the identification period, then the (g)(6) restrictions lapse at the end of the exchange period. The exchange period ends at the earlier of: (i) the time the exchanger acquires all identified replacement property; (ii) 180 days after the transfer of the relinquished property; or (iii) the tax return due date (including extensions) for the taxable year during which the sale of the relinquished property occurred if earlier than the date the replacement property is acquired the end of the 180-day period. The period during which the (g)(6) restrictions apply is the "(g)(6) period." During the (g)(6) period, the QI may distribute the exchange proceeds for only a very few reasons. During the (g)(6) period, the QI can distribute the proceeds to acquire valid replacement property and pay transaction costs. Otherwise, the QI must decline any requests to distribute the exchange proceeds during the (g)(6) period.

Real estate attorneys should help their clients avoid working with QIs that disregard the (g)(6) restrictions. The QI safe harbor only works if the exchange agreement includes the (g)(6) restrictions. If a purported QI is willing to make distributions that violate the (g)(6) restrictions as provided for in the exchange agreement, the distributions will negate the safe harbor as it applies to the exchanger. If the safe harbor is negated, the exchanger will most likely be deemed to be in constructive receipt of the proceeds held by the purported QI. The exchanger would therefore owe tax on all the gain realized on the sale of the relinquished property. What's worse, is the IRS could consider the (g)(6) language in all of the purported QI's documents to be illusory. If so, all of the agreements the purported QI has entered into would be deemed not to have the (g)(6) restrictions and the intermediary would not satisfy the QI safe harbor. In such a situation, all of the exchangers who have worked with that intermediary would likely be deemed to be in constructive receipt of the proceeds held by the purported QI. Real estate attorneys should be aware of this possibility and steer their clients away from QIs that do not enforce the (g)(6) restrictions. They should also help their clients understand that the benefit of using a QI comes with the cost of tying their exchange proceeds up throughout the duration of the (g)(6) period. Clients who understand this trade off typically concede that the QI should not distribute the proceeds before the end of the (g)(6) period.

5. Know the QI industry

Qualified intermediaries facilitate almost every section 1031 exchange. The QI industry has several hundred QIs, but not all QIs are equal, and the QI industry is unregulated. Consider three general types of QIs. A handful of national QIs are affiliated with title companies or banks. Such QIs typically have a corporate office with highly talented exchange specialists and people in regional offices with expert knowledge of section 1031 and the exchange process. Some QIs are privately owned stand-alone operations, but they can also be very sophisticated. Some real estate attorneys and exchangers have developed relationships with practicing attorneys who have side QI businesses. These three types of QIs (bank- or title company-affiliated, stand-alone, attorney side business) represent the vast majority of QIs.

The QI industry is not regulated, but, for the most part, QIs behave well and carefully manage the significant amount of cash they hold for exchangers. There are, of course, exceptions to the general practice. For instance, the financial crisis of 2008 exposed some QIs that had either stolen or mismanaged exchange proceeds. In one instance, Ed Okun purchased many privately-owned Stand-alone regional QIs and used the exchange funds as his personal piggy bank. In another instance, LandAmerica Exchange Services Inc. invested exchange proceeds in auction-rate securities that became illiquid during the financial crisis. At that time, QIs' "float" got quite a bit of attention. Float is the amount of exchange proceeds that a QI holds on average. For instance, a QI that does several hundred exchanges a year could have a float of $150,000,000. If the owner is comfortable that the float will never go below $100,000,000, the owner might become more aggressive in investing that amount in something like auction-rate securities that provide a return that beats typical deposits. Or, in Ed Okun's case, the owner might decide to "borrow" from the float to temporarily improve his lifestyle. Such strategies work if the float maintains its typical level. For the float to remain at its target level, however, deal-flow must remain constant to ensure that sufficient funds are flowing in to meet the demand to distribute funds. Unfortunately, the real estate market dipped during the financial crisis, slowing deal-flow, and causing the QIs' float to dip below its customary levels. LandAmerica Exchange Services got caught because the financial crisis froze auction-rate securities, causing them to become illiquid, and it could not convert those securities to cash fast enough to meet the demands to distribute exchange proceeds. Ed Okun had spent the money he took from the QIs he controlled, so he was in no position to return those proceeds and fund the demands for exchange proceeds.

When a QI fails, exchange proceeds get tied up in bankruptcy proceedings, at least temporarily. If funds are unavailable, exchangers cannot complete their exchanges. If exchangers needed the funds to close on replacement property they had under contract, they could be liable for breach of contract if they could not otherwise deliver proceeds to acquire that property. Of course, the loss of funds also creates financial hardship for exchangers when a QI collapses. It may surprise some observers to learn that over time the bankruptcy trustees of the failed QIs were able to return amounts to exchangers that were often within a few percentage points of the total amounts they had deposited with the QIs. Some of the funds came from the QI or assets under investment as they became liquid, but banks and other third parties who were close to the failed QIs also ended up paying into the bankruptcy estate in settlement of claims against them. Of course, recovery of the funds took months or years, so the exchangers lost the benefit of tax deferral on the sale of their property, and they could have recognized gain as the payments were received.

Inevitably, real estate attorneys get drawn into malpractice claims when some of their clients lose money in QI failure. Some such claims are without merit. For instance, claims that the attorney should have known about the financial health of a company like LandAmerica Exchange Services is unreasonable. Even though it was part of a publicly traded company, relevant facts about its financial stability and use of exchange proceeds were not published until the bankruptcy was announced. From an outsider's perspective, LandAmerica Exchange Services appeared to be a financially sound QI until it was too late for exchangers to do anything to protect themselves. Rumblings about Ed Okun were nothing more than rumblings until the very end. People who had suspicions about his activities did not have sufficient proof to expose his nefarious work until it was too late.

A few exchangers who had hired LandAmerica Exchange Services as QI had placed exchange proceeds in qualified escrow accounts, and they were able to obtain their proceeds much earlier than exchangers who simply had proceeds on deposit with LandAmerica Exchange Services. The distributions were probably too late to afford the exchangers the opportunity to complete exchanges, so they lost the tax benefit of section 1031. Some exchangers who saw that happen claimed that their real estate attorneys should have told them about the availability of qualified escrow accounts and qualified trusts. Those claims should put all real estate attorneys on notice, and they should consider advising their clients of the possibility of using a qualified escrow account or qualified trust in addition to hiring a trusted QI. Qualified intermediaries often have documents and systems in place to incorporate qualified escrow accounts and qualified trusts into exchanges, but they generally only implement such tools upon request from the exchanger. Real estate attorneys can apprise clients of those tools and request that the QI provide information about them.

6. Avoid accommodating accommodators

Because the QI industry is not regulated, real estate attorneys should ensure that their clients avoid purported QIs who cut corners and flout the rules. In addition to minimizing the importance of formal QI requirements and absconding with funds, QIs can do other things that jeopardize exchanges they are hired to help facilitate. As stated above, exchange agreements must include the (g)(6) restrictions, and exchangers must adhere to particular rules in identifying replacement properties within the 45-day identification period. Qualified intermediaries should help ensure that exchanges they facilitate comply with these rules. Some QIs get the reputation of being "accommodating accommodators" because they are willing to distribute proceeds prior to the end of the (g)(6) period. As discussed above, serious doubts exist as to whether such accommodators come within the definition of QI if they do not comply with the (g)(6) restrictions. Real estate attorneys should help their clients steer clear of such accommodators.

Some accommodators also are known to be willing to fudge on the identification rules. A talked-about trick such accommodators use is accepting a signed identification form within the 45-day identification period with reference to an attachment that lists the identified property. The trick being that the exchanger will later send the attachment, presumably after the end of the identification period, with the identified property. Not only would that be an invalid identification, it sounds like an effort to deceive the IRS, which could be fraud. Another talked-about trick is that exchangers will submit two sealed envelopes, each with identified properties and, after the 45-day identification period, let the QI know which letter to open and which one to dispose of. This, too, would violate the identification rules and would be a fraudulent identification. Real estate attorneys should avoid assisting with such shenanigans and should help their clients steer clear of accommodators who would entertain such tricks. The real estate bar should expect QIs to abide by the highest standards of professionalism and ethics and should refuse to work with QIs who do not abide by such standards.

7. Know the identification rules

Section 1031 allows exchangers to identify up to three properties without regard to the value of the properties (the three-property rule) or any number of properties if the total value of the identified properties does not exceed 200 percent of the value of the relinquished property (the 200 percent rule). Exchangers can identify properties at any time during the 45-day identification period and can revoke an identification at any time during that period and identify another property or let the period lapse with no identified property. As reiterated below, recognize that if you are assisting with a property that ceases to be a viable replacement property before the end of the identification period, let your client know that there is still time to identify something else or end the exchange and receive the proceeds after the end of the identification period.

8. Know the identification deadline

An exchanger must identify replacement property within 45 days after the transfer of the relinquished property. Real estate attorneys should know when the 45-day identification period ends for each transaction that they work on, especially if they are assisting with the acquisition of replacement property. Except in uncommon situations, such as the exchanger being affected by a federally declared disaster or serving in the U.S. armed forces in a combat zone, the 45-day period is not negotiable. Identifications can be revoked, so typically it is better to identify favorite properties a few days before the end of the identification period and change the identification at the last minute if needed than to miss the deadline altogether and fail to identify property. Be sure to revoke any prior identifications as needed to ensure that the total number or value of identified properties comes within the relevant prescribed limit.

COVID-19 has disrupted normal practices, affecting many exchangers' ability to complete section 1031 exchanges. The IRS issued Notice 2020-23 on April 9 extending the deadline for time-sensitive actions (including section 1031 identification and replacement-property acquisition) otherwise required to be completed between April 1 and July 15. Typically, such relief extends deadlines for 120 days or to the date in the IRS notice, whichever is later (whichever-is-later rule). Some observers are concerned that Notice 2020-23 might not apply the whichever-is-later rule and limit the extension to July 15. Nonetheless, a strong argument favors applying the whichever-is-later rule, which would extend affected section 1031 periods 120 days. Because commentators disagree about the length of the extensions, exchangers and their advisors must carefully study existing and future guidance when making decisions affected by the extension guidance.

Once the IRS issues guidance extending the section 1031 periods, the extensions appear to be elective, and they apply to the identification and exchange periods. The (g)(6) restrictions should also apply to those extended periods. Consequently, if an exchanger chooses to apply the extensions, the exchanger should plan for the exchange proceeds to be subject to the (g)(6) restrictions for the extended periods. Many exchangers will accept the prolonged restrictions to take advantage of the extra time and capitalize on any opportunities in real estate markets that might arise during the extended period, but they need to understand the risks of drawing money from a QI and leaving it on deposit.

Concerned for exchangers that were unable to complete exchanges due to COVID-19 and measures taken to protect against it, industry groups have requested that the IRS make the disaster date earlier than April 1, perhaps as early as January 20. Those groups argue that the extensions should apply to any exchange that begins between the earlier disaster date and July 15. The IRS has indicated that it will issue FAQs to address some of the uncertainty related COVID-19 and the extension dates, but the IRS had yet to issue that additional guidance as of the date this article went to press.

If you are assisting with the acquisition of a potential replacement property and realize before the end of the identification period that the exchanger will not acquire it, let the exchanger know. The exchanger can then remove it from the list of identified property and add a different replacement property to the identification form. If the property you are working on is the exchanger's only choice for replacement property and its acquisition becomes unrealistic, let the exchanger know to revoke the identification and receive the exchange proceeds after the end of the identification period. Remember that if the exchanger has property identified at the end of the

45-day identification period, the exchange proceeds will be tied up until the end of the exchange period. The exchanger should not be in that situation, if the exchanger has decided not to acquire any replacement properties. Do not let the identification period lapse with properties identified that the exchanger has no interest in acquiring or will otherwise be unable to acquire.

9. Use caution when deferring gain by straddling taxable years

Real estate attorneys should know that if an exchange straddles taxable years, gain typically is recognized in the year the funds become available. For instance, if an exchanger sells property in December 2020 and has a bona fide intent to do an exchange, as evidenced by hiring a QI to facilitate the exchange, the exchanger would not be able to access the exchange proceeds until sometime in 2021. If the exchanger does not identify replacement property and receives the exchange proceeds at the end of the 45-day identification period, the exchanger would recognize gain in 2021 when it receives the exchange proceeds under the installment method. This rule allows exchangers to defer paying tax for a year by deferring receipt of sale proceeds for 45 days. Some property owners might believe that they should take advantage of this one-year deferral by setting any sale up as a potential exchange. They can set a sale up as a potential exchange that defers gain for one year by timing it to come within the last month or so of the year (or last six months, if they are will to defer payment until the end of the exchange period) and hiring a QI to hold the proceeds.

Be aware, however, that if the exchanger uses the unadjusted basis of the property to allow for the 20 percent passthrough deduction under section 199A, it will lose the benefit of the unadjusted basis if it does not hold property at the end of the year. The lost deduction might not offset the benefit of deferring gain for a year. Exchangers can either choose not do an exchange or elect out of the installment method to ensure that gain is recognized in the year of the disposition, not the year the payment is received. If they wish to take advantage to the exchange property's unadjusted basis for purposes of the section 199A deduction, they should arrange to hold the relinquished property until after the end of the year or to acquire the replacement property before the end of the year.

10. Consider whether proceeds from blown exchanges may be investable in qualified opportunity funds

Consider whether the exchanger could try to invest any unused exchange proceeds in a qualified opportunity fund (QOF). Typically, a person can qualify for deferral by investing gain in a QOF within 180 days after property is sold. The QOF 180-day period can have multiple start dates for a single gain. For instance, if an individual sells property, the 180-day period generally begins on the date of the sale. If gain is recognized under the installment method, the QOF 180-day period begins, at the election of the taxpayer, when payments are received or at the end of the taxable year that the payments are received. To illustrate, if a person sold a property on July 15, 2020, for a note that qualifies for the installment method, the person would recognize gain when the note payments are received. Assume the person receives payments on March 1, 2021, and August 1, 2021. The QOF rules allow the person to start the QOF 180-day periods on March 1, 2021, and August 1, 2021, or to start a single QOF 180-day period for both 2021 payments on December 31, 2021. The person could also elect out of the installment method and start the QOF 180-day period on July 15, 2020.

Knowing the QOF 180-day period can be important for exchangers. If an exchange straddles two years and does not elect out of the installment method, the installment method defers the gain until the year of receipt. The QOF rules therefore appear to allow the 180-day period to begin on the date that the QI distributes exchange proceeds or December 31 of the year of distribution. If an exchanger sold property on July 15, 2020, and received any unused exchange proceeds on January 11, 2021, the last day of the exchange period, the first QOF 180-day period would begin on January 11, 2021, but the exchanger could elect for it to begin on December 31, 2021. The exchanger could also elect out of the installment method and have the QOF 180-day period begin on July 15, 2020. Because the exchange period and QOF reinvestment period are both 180 days, exchangers would not appear to gain an advantage by electing out of the installment method. If an exchange straddles two taxable years, the exchanger has multiple QOF 180-day periods starting on the following dates:

- The date the property was sold. The exchanger must elect out of the installment method to use this period. This period will run concurrently with the exchange period and often prevent the exchanger from investing in an opportunity fund during that period;
- The date the QI distributes exchange proceeds; and
- The last day of the taxable year during which the QI distributes exchange proceeds.

If a partnership transfers property, the general QOF 180-day periods apply to the partnership. If a partnership does not reinvest sale proceeds in a QOF, partners can reinvest their share of the partnership gain in a QOF. Partners can choose from several 180-day periods beginning on any one of the following start dates: (i) the date the partnership sells the property; (ii) the end of the partnership's taxable year; or (iii) the partnership's tax return due date. If a partnership is doing an exchange and does not elect out of the installment method, the partnership can use the QOF 180-day period beginning at the time the QI distributes the proceeds or it can use the December 31 (assuming that is the last day of the partnership's taxable year) of the year of the distribution. If the partnership does not reinvest the proceeds distributed from a QI, the partners can also use the 180-day periods that apply to the partnership, or they can use the 180-day periods beginning on the last day of the partnership's taxable year during which it receives the payments or its return due date for that same taxable year (usually March 15 of the year following the taxable year). Thus, assuming the partnership does not reinvest the exchange proceeds in a qualified opportunity fund, a partner could choose from any of seven different QOF 180-day periods to reinvest the exchange proceeds in a qualified opportunity fund starting on the dates described below.

Dates concurrent with the partnership:

- The date the property was sold. The partnership must elect out of the installment method and not reinvest the proceeds in a QOF for a partner to use in this period. This period will run concurrently with the exchange period and often prevent the exchanger from investing in an opportunity fund during that period;
- The date the QI distributes exchange proceeds; and
- The last day of the taxable year during which the QI distributes exchange proceeds.

Dates associated with the partnership year-end and return due date:

- Partnership elects out of installment method—(i) December 31 of year of sale; or (ii) partnership tax return due date for year of sale.
- Partnership does not elect out of installment method—(i) December 31 of year of receipt of proceeds; or (ii) partnership tax return due date for year of receipt of proceeds.

11. Don't drop the ball on a drop-and-swap

Drop-and-swaps have become commonplace, and many real estate attorneys see several of these types of transactions each year. A drop-and-swap is a series of transactions that often starts when a tax partnership (i.e., a partnership or LLC taxed as a partnership) receives an offer to purchase its property and the members disagree about how to reinvest the proceeds. Some members of the tax partnership might prefer to reinvest the proceeds in like-kind property as part of a section 1031 exchange; others might wish to do their own exchange, and others might wish to take cash and forgo other investments in real estate. To accommodate all parties, the tax partnership can consider liquidating by distributing tenancy-in-common (TIC) interests to each of the members. The members could then do as they please with their respective TIC interests.

Even though drop-and-swaps are easy to explain, they are complex transactions and have a few potential tax traps. When advising a client with respect to a drop-and-swap, remember that the property must be held as a TIC for tax purposes following the distribution. The advisor must understand the difference between a TIC and a partnership under tax law. For the members of a tax partnership to be treated as TIC co-owners, the partnership must distribute tax ownership of the TIC interests to the members, i.e., the members must acquire the benefits and burdens of the TIC interests.

If the partnership negotiates, the sale enters into the purchase agreement, and takes all of the actions necessary to sell the property, the IRS and courts could treat the partnership as holding the benefits and burdens and as owning the property at the time of the sale. If the partnership owns and sells the property, then it must complete the section 1031 exchange by acquiring the replacement property. Ensuring that tax ownership passes from a tax partnership to the member or members and that the post-distribution arrangement is a TIC, requires prior proper planning. Thus, it is best to get the wheels of a drop-and-swap turning well before the sale occurs.

12. Know what a TIC is and isn't

Having heard about drop-and-swaps, some real estate lawyers may believe that they can accomplish a good drop-and-swap by simply deeding the property from the partnership to the members as TICs right before closing. Unfortunately, tax law might not treat the ownership arrangement of a last-minute distribution followed immediately by a sale as a TIC. Experts in partnership classification believe that for an arrangement to be a valid TIC, it must have a few fundamental TIC characteristics. First, the members must generally have rights to partition the property and sell their TIC interests. Second, any blanket liens on the property should be borne by the members in proportion to their ownership interests. Third, revenue and expenses should be shared by the owners in proportion to their ownership interests. Fourth, the members should share in the management and decision-making related to the property. To comply with these requirements, co-owners of TIC arrangements typically adopt a TIC agreement and a management agreement.

Distributing TIC interests immediately prior to the sale of property raises questions about the status of the interest owned and transferred. If the property is held by the members for only an instant, the members may have difficulty establishing that the transitory arrangement was a TIC. For instance, they might not be able to show that they shared revenue and expenses according to their ownership interests, that they had rights to partition, that they had management rights, that they shared the blanket liens in proportion to their ownership interests, and that they satisfy the other criteria of a TIC for the brief instant between the distribution and the transfer. A properly structured drop-and-swap ensures that the property is distributed and held as a TIC before it is transferred to the buyer.

On the buyer side, exchangers often look to purchase TIC interests as replacement property. They may intend to hold those interests passively, or they may wish to participate in the management of the acquired property. For instance, a developer may wish to be part of a venture to acquire and develop land. The developer may prefer to acquire its interest in the property as part of section 1031 exchange. The developer cannot acquire a joint venture interest (i.e., an interest in a partnership or LLC) as part of an exchange, but it could acquire a TIC interest in the property to be developed. After establishing tax ownership of a TIC interest, the developer might consider contributing the property to a joint venture. From a tax planning standpoint, the developer is probably better off exchanging into a single TIC that will be folded into a joint venture (i.e., a quick TIC) than exchanging into a complex TIC that will develop property. A TIC that develops property often will be so complex that it could start to look like a tax partnership. Based upon Magneson v. Commissioner and its progeny,[4] the quick TIC can have

TIC tax attributes and then fold into the joint venture without negating the section 1031 exchange. With quick TICs, be certain the exchanger is the tax owner of the TIC interest and ensure that the stop transaction doctrine does not disregard that step.

Closely held TICs have become very prevalent. Sponsors of real estate funds and joint ventures want to use equity and management structures for such TICs that they use in their joint ventures, complete with profit-sharing and promotes. Some TIC arrangements have TIC agreements and management agreements that appear to comply with Rev. Proc. 2002-22 also include side letters that may introduce profit-sharing or management features that deviate from the guidelines in Rev. Proc. 2002-22. If the arrangements in the side letters would disrupt the TIC classification if they were in the TIC agreement or management agreement, they will likely disrupt the classification from outside those agreements. Because distinguishing between a tax partnership and a TIC is so difficult in many situations, one would not expect to see tax authorities aggressively challenge arrangements that do not perfectly comply with the Rev. Proc. 2002-22 conditions. Nonetheless, egregious deviations may attract the attention of taxing authorities, so don't deviate too far from the guidelines. Profit sharing that is not in proportion to ownership interests may be a deviation that strays too far from the guidelines, and it is easy for tax authorities to recognize and challenge. Some observers believe that arrangements within the entity structures of TIC owners might be a better way to deal with profit sharing and promotes. For instance, a manager may become a member of an LLC investor that is buying a TIC interest and get a profits interest for managing that entity or providing management services to it, instead of receiving a profits interest through the TIC management agreement. If the law respects every entity in the structure, then arrangements in the upper-tier entities or TIC should not disrupt the TIC classification. Issues related to side letters and agreements with structures are still being explored and fleshed out. Industry practices should normalize relatively quickly as demand for such structures grows. In the meantime, be careful to ensure that your arrangement does not become an example of how not to structure a TIC.

13. Know that an S corporation is not a tax partnership

Partnerships and S corporations are both pass-through entities, so they do not pay an entity-level tax. Instead, the income of both types of entities flows through to the members who pay tax on their respective shares of it. Despite that similarity, partnerships and S corporations are different in significant ways that are relevant in the section 1031 context. For instance, S corporations typically recognize gain when they distribute appreciated property to their members, and they must allocate recognized gain pro rata to the shareholders based upon the shareholders' ownership interests in the S corporation. Therefore, S corporations cannot do drop-and-swaps in the same way that partnerships can. If an S corporation simply distributes appreciated property to the shareholders, the corporation recognizes gain, allocates the gain to the members in proportion to their interests in the S corporation, and the members take a fair market value basis in the distributed property. After that gain recognition, the members would have no reason to do exchanges. If only one member wanted to cash out, the S corporation would recognize gain if it were to distribute an undivided interest to the cash-out member or receive cash boot on the sale of property as part of a section 1031 exchange, and it would have to allocate that gain pro rata to the members.

Shareholders do not, however, have to abandon all hope of dividing S corporations tax-free in proximity to doing an exchange. S corporations are subject to the general corporate tax rules, which allow for tax-free divisions. To obtain tax-free treatment on a division of a corporation, the division must have a non-tax business purpose, the pre-division corporation must have an active trade or business, the shareholders must retain their proprietary interests in at least one of the corporations that results from the division, and the business of the divided corporation must continue after the division.[5] These rules limit the types of S corporations that are eligible for tax-free divisions and may restrict the timing of such divisions. An S corporation may have difficulty satisfying the business purpose requirement if it distributes TIC interests to the members as part of the division. Often, the most obvious business purpose for doing a division is a management dispute and disagreement regarding the use and disposition of the corporation's property. If an S corporation has multiple members and multiple properties and divides the management of the properties among the members, a purpose for dividing may be to grant specific members greater management latitude with respect to specific properties. A fundamental attribute of a TIC is that the TIC owners participate in the management of the TIC property, so a division resulting in multiple corporations owning TIC interests probably would have to have a business purpose other than management differences.

An S corporation with multiple properties probably could do a tax-free division by distributing a property out to one of the shareholders. Following such a division, the new corporation and the dividing corporation would both hold at least one property. Each corporation should then be able to do a section 1031 exchange without disrupting the tax-free division. The division could, however, lose its tax-free status if either resulting corporation started but failed to complete an exchange. An S corporation should also be able to exchange out of one property into multiple other properties and then do a tax-free division. After a corporate division, the resulting entities will be corporations. Continued corporate ownership is not the ideal structure of real property (the owners would probably prefer to own the properties in tax partnerships), but a tax-free division does allow the owners to go their separate ways. Tax-free divisions of corporations have several technical requirements, so do them with care to ensure all the technical requirements are satisfied.

14. Recognize you're not a DST, NNN, or TIC broker

A significant marketplace exists for packaged replacement property, such as DSTs (interests in Delaware statutory trusts), NNNs (triple-net properties), and syndicated TICs. Each of these products provides passive investments for parties looking for real estate interests and minimal management responsibilities. For instance, triple-net properties are typically standalone properties with credit tenants. Exchangers often transfer out of property they have owned and managed and with which they are familiar into triple-net properties with which they have little or no familiarity. Some exchangers will visit such properties before acquiring them; others buy them sight unseen relying solely on financial information provided by the seller and the tenant's credit worthiness.

DSTs have become a popular form of replacement property. They allow investors to buy a fractional interest in a larger property or properties. A DST is a legal entity that tax law disregards if the DST satisfies certain requirements that create a fixed investment for members of the DST. The fixed investment requirement prohibits the DST from refinancing, making significant structural improvements to, or negotiating new leases for its property. Those restrictions should generally limit DSTs to owning new construction or recently renovated property. When property owned by a DST reaches a point that requires renovation, the DST must sell it.

Syndicated TICs were popular in the 2000s prior to the financial crisis, but they have lost their luster. An investor could probably find a syndicated TIC to invest in, but sponsors and lenders prefer DSTs because they employ a separate legal entity.

Investors should note how COVID-19 affects these types of arrangements. Rent payments and other revenue from the properties might decrease significantly for some types of properties, such as student housing, office buildings, and hotels. Reportedly, sales of DSTs that were on the market before COVID-19 have slowed. Loss of rent revenue will affect DST distributions. The situation at the time of this writing is worrisome for parties in the DST space. The speed at which the economy returns to normal will affect recovery of this market segment.

Real estate lawyers should be familiar with the legal aspects of TICs, DSTs, and triple-net replacement properties, but they should be careful not to promote any particular property. The industry is effective at getting their product in front of potential investors. Attorneys should be sure that any advice they give with respect to potential replacement property is within the scope of their representation, and they should recognize that not all products or sponsors adhere to the same standards of care and quality. Attorneys should also remember that their ethical duties require them to represent the client and should be certain any product their client is considering complies with section 1031 or other tax rules relevant to the transaction.

15. Use caution if replacement property comes from a related party

The IRS and courts do not like exchangers acquiring replacement property from related parties and generally deny section 1031 nonrecognition to such transactions. Courts have decided several cases with such facts, and the exchangers have lost in every case. The related-party exchange rules provide a defense for exchanges that are not tax motivated. Perhaps an exchanger could argue for the application of this no-tax-avoidance defense if the related party recognizes gain and pays more tax on more gain than the exchanger defers. An exchanger typically would not acquire property from a related party if the acquisition would not yield greater tax savings, so this no-tax-avoidance defense typically will not be available. If the related party recognizes gain but has losses to offset the gain, courts do not appear willing to grant the exchanger nonrecognition of gain on the exchange, even if the related party's recognized gain exceeds the exchanger's deferred gain.

16. Know that serial exchanges are an exception to the general related-party prohibition

One exception to the rule prohibiting the acquisition of replacement property from a related party is a transaction in which the related party uses the proceeds to do its own exchange. With such transactions, the IRS has privately ruled that the exchanger's and related party's exchanges can qualify for section 1031 treatment. The related party can also acquire its replacement property from a second related party if the second related party does a section 1031 exchange. An ownership structure with several properties owned in several different related tax entities such as a large REIT or real estate fund, could string several exchanges together with a series of connected exchanges. The ability to string exchanges together in this manner gives these structures the appellation "serial exchanges" or "daisy-chain exchanges."

The benefit of serial exchanges should be obvious. If the related-party group is considered a single economic unit, then serial exchanges allow the economic unit to extend the 45-day identification period and 180-day exchange period indefinitely. If an exchanger anticipates it will not be ready to complete the exchange within its 180-day exchange period, it can identify a related party's property and acquire it prior to the end of the 180-day period. The related party then has 45 days to identify replacement property and 180 days to acquire it. If the related party is concerned that it won't be able to acquire replacement property within its 180-day exchange period, it can identify another related party's property and keep the chain going by acquiring replacement property from that other related party. The possibility of benefitting from serial exchanges may prompt some property owners to structure ownership of multiple properties with multiple related entities. Creating related parties to own separate properties can also lay the groundwork for doing leasehold improvement exchanges.[6]

17. Selling to a related party is probably fine

The IRS allows exchangers to sell relinquished property to a related party and do an exchange (through a QI) with the proceeds the related party pays for the property. Knowing this can come in handy if the exchanger is considering doing a so-called Bramblett exchange in which it locks in capital gain treatment on property held for investment before selling it to a related-party developer.[7] The investment entity in such a transaction should be able to use the proceeds from the sale to the related-party developer to do a section 1031 exchange (if the developer entity acquires the property with a note, then the transaction will require additional planning). There may be other reasons for selling property to a related party as part of a section 1031 exchange, so be aware that the IRS has sanctioned such transactions.

18. Know when the exchange period ends

The exchange period runs until 180 days after the exchanger transfers the relinquished property. That period can be cut short if the tax return due date for the year of the exchange is before the end of the 180-day period. Know that your client can avoid having the 180-day period cut short by filing an extension. Thus, if an exchange starts towards the end of the taxable year (assuming a calendar taxable year) and the 180-day period will end after March 15, if the exchanger is a partnership or S corporation, or after April 15, if the exchanger is an individual or C corporation, let your client know to file an extension to get the full benefit of the 180-day period, assuming the exchanger needs additional time to complete the exchange. Due to COVID-19, the 2020 filing deadlines between April 1 and July 15 have been extended until July 15.[8] Such extensions are not typical, but when they happen they could be relevant to the exchange period. If the exchanger prefers to receive exchange proceeds and not continue the exchange, advise the exchanger to not extend the return and to not take advantage of any extension relief. When the exchange period ends, the (g)(6) restrictions cease to apply.

The 180-day period can only be extended by the IRS for a limited number of reasons, which require other federal action, such as a federally declared disaster.[9] Absent such an extension, the 180-day period is definitive, and it can end on a holiday or weekend, so be sure to close on property before the end of the exchange period, if necessary.

19. Follow the money: replace value, replace equity

Cash is king in section 1031 exchanges, just like it is with most other things, because an exchanger's actual or constructive receipt of cash will trigger gain recognition. Real estate attorneys should pay close attention to the flow of funds, ensuring that proceeds from the sale of relinquished property get to the QI and get used to acquire replacement property. To totally defer gain, an exchanger must acquire replacement property that is equal to or greater in value than the relinquished property (the equal-value rule), and the equity (value of the property minus the debt encumbering it) in the replacement property must be equal to or greater than the equity in the relinquished property (the equal-equity rule). Thus, if the relinquished property has debt, the exchanger can defer all of the gain on the sale of that property only by replacing the debt or putting additional capital into the acquisition replacement property.

Often, acquisition financing will include funds for capital improvements to the replacement property. In such situations, the sum of the loan proceeds and exchange proceeds coming to closing might exceed the value of the replacement property (perhaps the extra proceeds will be used for capital improvements), but the exchanger must comply with the equal-value rule and the equal-equity rule to avoid gain recognition. Assuming the replacement property satisfies the equal-value rule, the exchanger can satisfy the equal-equity rule only by ensuring that all of the exchange proceeds are used to acquire the replacement property and any extra cash comes from financing. The most conservative way to ensure that the extra cash comes from a loan is to close on the replacement property and then enter into a new loan for the extra proceeds. Often that course of action is not feasible because the lender will only do one set of loan documents and is not interested in delaying the distribution of proceeds. A next-best course of action is to ensure that the closing statement clearly identifies the exchange proceeds being used to acquire the replacement property and that any cash the exchanger receives comes from the loan.

At a courtesy meeting with the IRS as part of the American Bar Association Tax Section meeting in May 2019, attorneys at the IRS Chief Counsel's Office indicated that tracing exchange proceeds from the QI to seller and loan proceeds from the lender to exchanger is acceptable. They suggested that as long as the exchange satisfies both the equal-value rule and the equal-equity rule (the loan proceeds received by the exchanger at closing would not be considered debt for purposes of computing the property's equity), the cash received at closing should not be treated as boot. Although such communication is not an authoritative statement of law, it did give confidence to the practitioners present at the meeting to move forward with such transactions when no other alternatives are feasible.

Real estate attorneys should also be mindful that closing adjustments can have tax consequences. Transaction costs, such as attorneys' fees, transfer taxes, QI fees, brokers fees, and survey and engineering fees, paid at closing reduce the amount realized of sold property or increase the basis (i.e., cost) of acquired property (in the case of purchased property, but use of exchange proceeds to pay those costs should not affect the basis of property acquired in an exchange), so they do not affect the taxability of an exchange. Adjustments for prepaid rent, taxes, security deposits, and other items can have tax consequences. Any exchange proceeds used to pay such items for the seller will be boot to the seller. If the items are deductible, the deduction will offset the boot, but if the parties can ensure that the exchange proceeds go to the QI and the adjustments get paid outside the closing, the seller could take the deduction against other income.

In the case of security deposits transferred to the buyer, if the deposits are paid out of exchange proceeds through a credit to the purchase price, the buyer would most likely have boot and have no offsetting current deduction. In such a situation, the buyer should insist upon having the seller write a separate check to transfer the security deposits. Real estate attorneys should take the closing statement seriously and identify any items that could trigger boot. Some exchangers may prefer to settle those items on a separate closing statement and use proceeds from sources other than the exchange proceeds to pay for those items.

20. Have the best section 1031 people in your contacts folder

Section 1031 has become commonplace and many real estate attorneys have done dozens, hundreds, or even thousands of section 1031 exchanges. Such attorneys are very familiar with the section 1031 exchange process, but many exchanges involve complex tax matters or tax issues outside of section 1031. Get a section 1031 expert on board whose expertise covers section 1031 and other relevant areas of tax law to ensure that all technical requirements are satisfied and other tax issues are considered.

Section 1031 can be a wonderful tax-saving device. Some exchanges seem routine, and you may feel comfortable relying solely on the QI for tax advice regarding your exchange. Use caution in doing so. Qualified intermediaries generally include disclaimers in their documents and marketing materials providing notice that they do not provide tax advice. If they are not your client's attorney their communication may not be protected by the attorney-client privilege, and the QI may not be subject to the rules of ethics that govern attorneys.

Qualified intermediaries will become disqualified if their advice extends beyond advice with respect to exchanges intended to qualify for section 1031 nonrecognition.[10] The QI rules do not establish the parameters of what constitutes advice with respect to an exchange intended to qualify for section 1031 nonrecognition, so one cannot know with certainty if a QI crosses that line. If the advice is limited to the identification rules and the identification and exchange periods, then most observers would agree that the advice is with respect to an exchange intended to qualify for section 1031 non-recognition. If the advice relates to whether a TIC is a partnership or whether a drop-and-swap qualifies for non-recognition on both the distribution and the exchange, then the advice may cross the line and relate to classification of an arrangement and tax treatment of a partnership transaction. If that happens, then the QI safe harbor could cease to apply, and the exchange may not qualify for nonrecognition.

To avoid those problems and ensure that all aspects of a section 1031 are properly considered and applied, recommend that your client hire a section 1031 expert to assist with the exchange. Even when the exchange seems simple, if the dollars justify hiring an expert, don't take chances—get an extra set of expert eyes to review the exchange. It can't hurt to have a set of trained eyes review every aspect of the exchange. If the transaction is complex, definitely suggest that your client enlist expert help to assist with planning and executing the transaction. The cost of such help will be slight compared to the cost of defending problems that arise from oversight or neglect of important issues.

Conclusion

Section 1031 is a great tax-saving mechanism and section 1031 exchanges are ubiquitous. Real estate attorneys are on the front lines of exchanges. They should be mindful of situations that lend themselves to section 1031 treatment and help their clients understand the benefits of section 1031 deferral. Real estate attorneys should also be aware of issues that come up in section 1031 exchanges and be prepared to handle those issues or bring in tax specialists to help with those matters. Interesting and perplexing issues can arise even in what appear to be straightforward, simple exchanges. By being mindful of the 20 issues discussed in this article, real estate attorneys can help reduce the risk of overlooking a relevant issue or matter and help ensure that an intended exchange obtains the tax goals the exchanger is pursuing.

Notes

1 See Bradley T. Borden, "20 Things Real Estate Attorneys Can Do To Not Mess Up a Section 1031 Exchange (Part 1 Items 1-10)," in the May issue of The Practical Tax Lawyer.

2 For an in-depth discussion of extensions of the section 1031 periods, see Bradley T. Borden, "Universal Deadline Extensions Draw Attention to Section 1031 Periods," 167 Tax Notes Fed. 603 (Apr. 27, 2020). See also American Bar Association Section of Taxation, "ABA Tax Section Follows Up on Preliminary COVID-19 Remarks," 2020 TNTF 85-21 (Apr. 29, 2020); Letter from Real Estate Coalition Requesting Clarification of Disaster Relief for § 1031 Exchanges (Apr. 20, 2020), available at https://v6k8u5d3.stackpathcdn.com/wp-content/uploads/2020/04/LKE-Coalition-letter-to-Treasury-IRS-re-Notice-2020-23-4.20.20.pdf?x44329..

3 See Kristen A. Parillo, "FAQ Coming on Like-Kind Exchange Extensions," Tax Notes Federal, Apr. 20, 2020, p. 527.

4 For an in-depth discussion of those cases, see Bradley T. Borden, "Section 1031 Drop-and-Swaps Thirty Years after Magneson," 19 J. Passthrough Ent. 11 (Jan.-Feb. 2016).

5 See I.R.C. § 355; Treas. Reg. § 1.355-1, -2.

6 See Bradley T. Borden, 20 Things Real Estate Attorneys Can Do To Not Mess Up a Section 1031 Exchange (Part 1 Items 1-10), supra; "Build-to-Suit Ruling Breaks New Ground for Taxpayers Seeking Swap Treatment," 98 J. Tax'n 22 (Jan. 2003) (with Alan S. Lederman and Glenn Spear).

7 See "Accounting for Pre-Transfer Development in Bramblett Transactions," 41 Real Est. Tax'n 162 (3rd Quarter, 2014) (with Matthew E. Rappaport); "A Case for Simpler Gain Bifurcation for Real Estate Developers," 16 Fla. Tax Rev. 279 (2014) (with Nathan R. Brown & E. John Wagner, II).

8 See I.R.C. 7508A; Notice 2020-23, 2020-18 I.R.B. 1; Rev. Proc. 2018-58, 2018-50 I.R.B. 990.

9 See id.

10 See Treas. Reg. § 1.1031(k)-1(k).