SECTION 1031 TAX-DEFERRED EXCHANGE REPLACEMENT PROPERTY PROGRAMS: A BRIEF HISTORY

by Louis J. Rogers*

I. INTRODUCTION TO SECTION 1031 TAX-DEFERRED EXCHANGES

A. Section 1031 – Tax Deferral

Section 1031 of the Internal Revenue Code provides that no gain or loss shall be recognized if property held for productive use in a trade or business or for investment is exchanged solely for property of like-kind to be held for productive use in a trade or business or for investment. Section 1031 provides an *exception* to the *general rule of current gain recognition* (taxation) on the sale or exchange of property. In a qualifying Section 1031 exchange, the gain that otherwise would be recognized (taxed) is *deferred* until the replacement property is transferred in a later taxable transaction. Note that the replacement property may be transferred in another qualifying exchange, continuing the deferral. Some taxpayers exchange over and over again throughout their lifetime in a series of transactions called “swap until you drop”. While this is technically deferral and not exclusion of taxable gain, the gain may be deferred for a very long time.

The exchange concept has been a part of the Internal Revenue Code since 1921 and reflects Congressional policy not to tax theoretical gains where the taxpayer has continued his or her investment in like-kind property. The Commonwealth of Virginia generally conforms to federal tax law and provides comparable deferral of state income taxes for qualifying exchanges.

B. Identification and Other Section 1031 Exchange Issues

Section 1031 is highly technical and includes numerous complex requirements, including the following:

Identification of replacement property – in a non-simultaneous or delayed exchange, all replacement property must be “identified” in writing within 45 days of closing the relinquished property;

Multiple property identification – three (and sometimes more) properties may be identified as potential replacement property;

Closing deadline – all replacement property must be acquired by the *earlier of* 180 days or the due date of the taxpayer’s tax return (with extensions);

Replacement property debt requirement – reduction of debt in an exchange is taxable; debt secured by the relinquished property must be offset with debt secured by the replacement property; and

Taxable boot – any cash or non like-kind property received in the exchange is taxable (commonly referred to as “boot”).

These rules can be difficult to apply in the real world and may create numerous traps for the unwary.

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II. RISE OF SECTION 1031 EXCHANGE PROGRAMS STARTING IN THE LATE 1990'S

A. Low Tax Basis Means High Taxable Gains

Many exchangers have long-term ownership of a rental house or investment property with a low tax basis; others own properties that were inherited many years ago and also have a low tax basis. For most taxpayers, low tax basis means high taxable gains (federal and state) on sale.

B. Simultaneous vs. Non-Simultaneous Exchanges

In a simultaneous exchange, the exchanger transfers the relinquished property and acquires the replacement property *at the same time*; both legs of the exchange occur simultaneously. In a non-simultaneous exchange, sometimes referred to as a "delayed" exchange, the exchanger transfers the relinquished property and acquires the replacement property *at a later date*. Section 1031 was amended in 1984 to permit non-simultaneous exchanges, which can be helpful to exchangers who need additional time to acquire replacement property. Today, almost all exchanges are non-simultaneous or delayed.

C. Typical Section 1031 Challenges

Most exchangers acquire a "whole" property (i.e., 100% of a property) as their Section 1031 replacement property. However, many exchangers are not active in the real estate business and struggle with the requirements of Section 1031; some fail to satisfy the technical requirements and, despite their best intentions, will have to pay federal and state taxes. The biggest challenges for most investors include:

Sourcing (finding) the replacement property;
Conducting due diligence;
Identifying replacement property within 45 days in compliance with Section 1031; and
Placing the required level of debt on the replacement property to satisfy Section 1031.

The starting point is the replacement property; exchangers must locate desirable replacement property to be held for productive use in a trade or business or for investment. Smaller investors frequently do not have access to a broad menu of replacement property. They can engage a realtor or real estate broker, but this is foreign territory for many.

In a non-simultaneous or delayed exchange, all of the replacement property must be "identified" in writing typically sent to the qualified intermediary (or accommodator) holding the exchange proceeds. The identification must be sent within 45 days of closing the relinquished property. *Failure to properly identify will result in the entire transaction being fully taxable.*

The 45-day identification clock starts ticking when the relinquished property is sold for tax purposes (not necessarily the date on the settlement statement), and there are no extensions (barring a Presidentially-declared disaster, terrorism or military action).

What if the timing is bad to identify all replacement property by the 45th day? For example, what if:

the pricing of desirable properties is high?
the inventory of available properties is low? or
the exchanger is on vacation and does not have time to find replacement property?

There is no relief: the 45-day identification requirement is inflexible. Failure to properly identify will result in *the entire transaction being fully taxable*.

Additionally, what if the exchanger has located several prospective replacement properties and has not decided which one or more to acquire? Taxpayers can always identify three properties of any value, and sometimes more, using the so-called 200 percent rule or the 95 percent exception. However, multi-property identification is problematic; a number of taxpayers inadvertently over identify, which results in the entire transaction being fully taxable.

Prudence dictates that exchangers conduct extensive due diligence on replacement property, including the following:

Feasibility of the property for its intended use;
Financial strength of tenants;
Property condition;
Zoning;
Title;
Survey; and
Environmental.

However, customary due diligence is beyond the ability of many smaller investors; delegating the due diligence process to attorneys, CPAs and consultants can be very expensive and may be impractical on smaller properties. This creates a dilemma for less sophisticated exchangers who understand that prudence dictates extensive due diligence but who lack the skills or want to incur the cost to obtain professional help.

Taxpayers must reinvest the precise amount of net proceeds from the sale of their relinquished property. For example, a taxpayer with $192,379.99 of net proceeds from their relinquished property must reinvest that exact amount in the replacement property (note, taxpayers may "trade up" by adding cash to the exchange to acquire a larger property). However, whole replacement properties do not come in the exact size needed for a given taxpayer. Any portion of the sales proceeds not reinvested will be taxed as "boot".

Also, taxpayers must offset debt on the relinquished property with an equal or greater amount of debt on their replacement property. For example, a taxpayer with $299,379.33 of debt secured by their relinquished property (that was repaid or assumed at closing) must acquire replacement property secured by that precise amount of debt. (Note: taxpayers may bring after-tax cash to the exchange to offset or reduce debt and qualify for Section 1031).

Many smaller exchangers struggle to reinvest the exact amount of proceeds from their relinquished property, and others do not have access to commercial real estate lenders to obtain the required amount of debt to achieve complete tax deferral under Section 1031. Many taxpayers do not want to sign notes personally or provide a guaranty to obtain a necessary real estate loan. Some desirable properties may not qualify for the required level of debt.

Still other taxpayers own actively-managed real estate, such as rental houses or business properties, but seek more passive replacement property. They may have access to other rental houses or properties but no longer want to deal with the "tenants, toilets and trash"; they desire a more passive investment.

There is good news for real estate investors--many of the exchange challenges have been overcome by real estate firms, known as "sponsors," who have created Section 1031 exchange programs to provide turn-key replacement property that can be purchased in the exact equity amount needed, with non-recourse debt in place, and all the due diligence completed.

D. "Whole" Replacement Property; Net Leased Properties

Typically, most exchangers acquire a "whole" replacement property (that is, 100 percent of a property). But many real estate investors struggle with the requirements of Section 1031 and some will fail without professional help. Due in part to the difficulty of satisfying the requirements of Section 1031, a number of real estate firms (for example, Calkain Companies in Northern Virginia: www.calkain.com) have developed a specialty in brokering "net leased" retail properties, such as Walgreens and CVS pharmacies. Such properties have become commoditized in part because they are relatively easy for exchangers to find, conduct due diligence, identify within 45 days, finance, and acquire.

The net lease structure is desirable to exchangers who want a more passive investment because the tenant typically is required to make all repairs and replacements during a long lease term. Furthermore, the tenant typically pays all taxes, insurance, maintenance and repair costs (this is a classic "triple net" lease; there are many variations) putting the risk of inflation on the tenant.

Over the past ten years, net leased retail properties have become the replacement property of choice for a large number of exchangers who want a whole property in a passive structure. But there are challenges; it may be difficult to match up the exchanger's equity and debt requirements with a given property in time to satisfy Section 1031's timing requirements and net leased properties have been selling for record prices, which has driven down investor returns compared to other asset classes.

In conclusion, net leased assets are relatively plentiful and easy to own as replacement property due to the net lease structure. However, prudent exchangers still must conduct extensive due diligence and must satisfy the timing and debt requirements imposed by Section 1031. For many taxpayers, net leased assets are an imperfect replacement property solution.

E. Syndicators to the Rescue in the late 1990's with TIC Programs

Beginning in the late 1990's, a handful of real estate syndicators familiar with real estate partnerships began to syndicate fractional interests in real estate specifically structured for exchangers. These offerings became known as Tenant in Common, or TIC, offerings because the exchangers acquired an undivided Tenant in Common interest in the replacement property. Triple Net Properties, LLC, Passco Companies and Inland Private Capital Corporation were early adopters of the TIC structure.

TIC programs typically were sold as securities through independent broker-dealers across the nation. The goal was to provide a quality replacement property in a more convenient form for smaller investors who did not want to source, conduct due diligence, finance, and manage their own replacement property. Over time, TIC sponsors created a turn-key product where the due diligence was complete, the loan was in place, and the TIC interest could be acquired quickly, simply and with certainty to satisfy the strict requirements of Section 1031. Sponsors of TIC programs also provided full scope property and asset management services, creating a passive investment sought by many aging baby boomers.

The first round of TIC offerings from 1999 to early 2002 was structured based on the analysis of tax counsel who rendered legal opinions that the TIC interest "should" qualify for 1031 treatment; this was prior to specific IRS guidance issued on March 19, 2002. Attorneys at the Hirschler Fleischer law firm in Richmond, Virginia, were at the forefront of this industry in crafting TIC programs for numerous sponsors across the nation.

F. Rev. Proc. 2002-22 Validates TIC Programs

On March 19, 2002, the IRS issued unprecedented guidance commonly referred to as the "Rev. Proc." that essentially validated the TIC structure. With the tax status finally nailed down, the sale of TIC interests sky rocketed. According to widely reported industry statistics, TIC *equity* grew from less than \$200 million in 2001 to over \$3.8 billion in 2006. Clearly, 2006 was the high-water mark (before the 2007-2011 recession), when sponsors sold over \$7 billion of TIC real estate to exchangers. TIC programs became a national phenomenon, sold by hundreds of broker-dealers from coast-to-coast. Back in 2006, while waiting in a grocery store line in Southern California, the author once heard two soccer moms discuss the recent sale of their TIC property and exchange into a new TIC property. At the time, it felt as if TICs had become an overnight sensation.

III. POST-RECESSION ENTITY OF CHOICE: DELAWARE STATUTORY TRUST

Following the 2007-2011 recession, TIC lending essentially ended. Over time, lenders started making loans to a different qualifying structure known as a Delaware Statutory Trust, or DST, that may be used to accomplish the same tax-deferral as a TIC. DSTs are widely used today for virtually all fractionalized 1031 programs. TICs are no longer a viable structure for syndicated 1031 programs.

A. History of DST

DSTs were formerly known as Delaware Business Trusts and have been in use for many decades. A DST is a flexible, unincorporated entity formed under Delaware law and can be used for many purposes, including real estate ownership. DSTs were used occasionally before and after issuance of the Rev. Proc. to overcome some of the limitations of the TIC structure, but the TIC structure was predominate until after the 2007-2011 recession, when most lenders refused to make loans to TICs. From 2011 to date, almost all syndicated fractionalized 1031 programs have used the DST structure.

B. Revenue Ruling 2004-86

Like the Rev. Proc issued in 2002 for TICs, Revenue Ruling 2004-86 (the "Ruling"), provided needed guidance on DST qualification for tax deferral under Section 1031. To qualify, a DST must satisfy a number of strict requirements and avoid any of the so-called "seven deadly sins". A detailed discussion of the Ruling is beyond the scope of this article. Bottom line – only passive real estate qualifies for Section 1031 treatment in a DST. This means that DST programs may be used to hold net leased real estate or active real estate subject to a master lease that makes the investment passive to the investors.

C. Tax Opinions

Sponsors of DST offerings provide a legal opinion from tax counsel that the DST interests should "qualify" for Section 1031 treatment. This is a positive feature of syndicated DST offerings. Coincidentally, Virginia law firms, such as Kaplan Voekler Cunningham & Frank, PLC and Hirschler Fleischer, have been instrumental in creating TIC and DST programs for sponsors across the nation.

D. Key Attributes of DST Programs

When compared to TICs, DST offerings have a number of positive attributes for investors, including:

DSTs have a simpler and less costly closing process because investors are not on title.

DSTs have a much lower minimum investment, making it possible for even small exchangers to diversify into several replacement properties.

DSTs are sold in dollar increments, which means that exchangers can invest their precise amount of net proceeds, making DST investments one size that fits the equity needs of most exchangers.

DSTs interests are more freely transferable than TICs, making DSTs preferred for family gifting and estate planning.

DST interests solve a number of problems experienced by real estate investors, especially small real estate investors who frequently struggle with the requirements of Section 1031. The biggest challenges for most investors include: sourcing replacement property, conducting customary due diligence, identifying replacement property within 45 days, and placing required debt on the replacement property. DSTs solve these challenges for many exchangers.

E. Strictly Passive Ownership Structure

The Ruling requires DST investors to be passive owners of replacement property. This excludes many categories of active real estate unless the sponsor uses a master lease structure to make the investment passive to the investors.

IV. CONCLUSIONS

A. Creativity/Evolution

The leading 1031 sponsors have been exceptionally creative in structuring fractionalized real estate offerings to qualify for Section 1031--first TIC offerings and, now, DST offerings. Future structures will evolve over time to conform to applicable tax requirements and possibly changing demographics of exchangers (for example, a number of aging baby boomers seek passive debt-free, all cash replacement property).

B. IRS Support

The IRS has consistently supported Section 1031 with guidance, including the Rev. Proc., the Ruling and a large number of private letter rulings, technical advice memoranda and the like. Back in 1991, regulations were issued on non-simultaneous or delayed exchanges that included the use of a qualified intermediary or accommodator to hold exchange proceeds. This “safe harbor” eliminated concerns about taxpayers being taxable due to actual or constructive receipt of sales proceeds. Over time, the cost of using a qualified intermediary or accommodator has declined to the point where even small transactions can be cost-effectively structured as an exchange.

As the body of favorable tax guidance grows, a greater number of taxpayers have acquired DST investments as their 1031 replacement property. The modern DST is particularly efficient in keeping transaction costs to a minimum, works well for smaller investors, and provides additional comfort of a “should” qualify tax opinion from a national law firm. To twist a famous quote, “today, even the little people DO NOT have to pay taxes” when they exchange.

Coincidentally, members of the Virginia bar are widely regarded as some of the leading innovators who helped develop both the TIC and DST structures for Section 1031, from the late 1990s to the present. Further, frequently it is members of the Virginia bar who provide “should” qualify tax opinions for DST offerings on a national basis.

C. Change is the Only Constant

From whole properties to TICs, and now from TICs to DSTs, legal structures come and go, but sponsors, with the assistance of expert legal counsel, define and redefine the optimal structure for tax deferral under Section 1031. Large and small real estate investors who struggle with the technical requirements of Section 1031 are the beneficiaries of the improvements as exchange programs evolve and improve over time.