A Tale of Two Transactions

Tax-deferred Strategies for Property Owners

BY MICHAEL MALAKOFF – MANAGING DIRECTOR, CENTER FOR WEALTH IMPACT
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It was the best of times. It was the… best of times (sorry Dickens). With significantly raised values since the economic downturn of 2008-2009 and rents – especially for those in the San Francisco Bay Area – at record highs, many of our real estate clients seem to be in fantastic positions to capitalize on a true fairytale moment for commercial property. In spite of, or perhaps because of, this strong showing, a growing number seem to be ready to cash in their chips. The motivating factors we see are threefold: to diversify real estate holdings, move to a new product type, or exit the market altogether.

We cannot say whether this indicates a peak in the market or frothiness in certain product types or geographic areas. Rather, our focus in this article is to identify two tax-deferred strategies for commercial property owners who seek alternatives to outright sales and prefer to remain invested in real estate, directly or indirectly. And so begins our tale of two transactions:

TALE #1: IRC §1031 EXCHANGES

The first strategy is the simpler one to discuss. In its basic form, Internal Revenue Code (IRC) Section (§)1031 allows real estate owners—whether individuals, partnerships, corporations, limited liability companies (LLCs) or trusts—to exchange one piece of real property for another, without triggering capital gains recognition through a taxable event. By reinvesting in essentially the same type of enterprise, owners can defer tax on any gains and thus allocate their capital and resources more efficiently.

THE DEVIL IS IN THE DETAILS

The primary requirement of a §1031 exchange is that both the relinquished property and the replacement property must be part of an integrated transaction rather than two individual transactions. To prevent gains recognition, you must acquire “like-kind” property by 1) simultaneously swapping properties; 2) engaging in a deferred, non-simultaneous exchange; or 3) taking part in a reverse exchange. What’s more, you can roll over from one property to another, time after time. As long as the exchange falls under the basic like-kind rule (along with some other rules the IRS stipulates), you can avoid paying tax on any profit until you actually sell the real property for cash.
The exchange of real property for real property is relatively straightforward; not quite as easy as swapping deeds, but nearly so.

Fortunately, the IRC defines the like-kind requirement very broadly. Most real estate will be like-kind to other real estate—for example, you can exchange an apartment building for vacant land or a ranch for a strip mall. However, there are two important exclusions to the general rule: first, real property outside of the United States is never like-kind to U.S. real estate, and second, personal property can’t be like-kind to real property. The IRC also specifically excludes inventory or stock in trade; stocks, bonds or notes; other securities or debt; partnership interests; and certificates of trust.

While personal property may qualify for a §1031 exchange, the rules are more restrictive. See “When the Transaction Is Personal,” below.

**When the Transaction Is Personal**

Compared with real property, the IRC takes a much narrower view of whether you can use a §1031 exchange for personal property. Two properties you assume will qualify, seldom do—say, a car exchanged for a truck, or a beef cow for a milk cow. The hurdles for like-kind tax-deferral are more difficult to achieve. That’s because personal property exchanges must fall within the same General Asset Class, as described in the North American Industry Classification System (NAICS).

**THE ART OF THE DEAL**

In a deferred exchange, often called a delayed or a Starker exchange (named for an investor who challenged and won a case against the IRS), you actually sell real property rather than exchange it. Normally, this would trigger capital gains recognition. Similar to rollover rules for a 401(k), taking control of cash or other proceeds before the swap is complete may disqualify the entire transaction from like-kind exchange treatment and make all gains from the transaction immediately taxable. One way to avoid premature receipt of cash or other proceeds is to designate a “qualified intermediary,” or facilitator, to hold your sale proceeds until the exchange is complete.

You must choose a neutral person as facilitator. The IRS specifies that you or your agent (including your real estate agent or broker, investment banker or broker, accountant, attorney, employee or anyone who has worked for you in those capacities within the previous two years) cannot act in this role. Banks and other companies designed for this purpose are frequently used as qualified intermediaries. As with all financial dealings, make sure the qualified intermediary you choose has the capabilities and resources needed to meet its contractual obligations.
THE ESSENTIAL INGREDIENT IS TIMING

Your entire gain from a deferred exchange will be taxable if you fail to meet the following timeline. Countdown begins on the date you sell the relinquished property.

- 45 calendar days to identify potential replacement properties to your facilitator in writing. The most common method is to identify three replacement properties. You can identify four or more properties, but their total fair market value must not exceed 200% of the fair market value of your relinquished property.
- 180 calendar days to purchase and close the new property (or by the date of filing your next tax return, plus extensions, if earlier).

These two periods run concurrently, and there are no extensions for any reason, except for what the IRS terms a “federally declared disaster.” The timeline for simultaneous swaps also totals 180 calendar days.

MOVING IN REVERSE

A reverse exchange is a three-party transaction that turns the normal old-for-new property swap upside down. It lets you move quickly to purchase a promising property, yet still receive the tax treatment of a §1031 exchange, if you follow certain guidelines. As with a deferred exchange, you designate a qualified intermediary. Additionally, the intermediary establishes an exchange accommodation titleholder (EAT)—a single-member LLC. The EAT takes title to, or “parks,” the desired property for you, holding it until you are able to sell the old property.

The timing to complete the transaction is the same as a simple swap or deferred exchange; the order just switches. You have 45 days from the date the EAT parks the new property to identify the property you’re relinquishing, and the total process must conclude within the 180-day limit from the date of the EAT’s purchase.

MINIMIZING THE TAX BITE

While most property owners who initiate a §1031 exchange would view complete tax deferral as the ideal outcome, it’s not always possible. Certain aspects of the transaction could result in “boot”—cash left over at the conclusion of the exchange. Receiving boot won’t disqualify the transaction, but the boot itself will be taxable as partial sales proceeds and generally treated as a capital gain. Apart from making sure to trade across or up in property value, another common way to avoid or minimize boot is to bring enough cash to the closing of the replacement property to cover loan fees and other non-transaction costs.

As a postscript, sometimes the goal is to trade down in property value or exclude a portion of the equity, with the full understanding that boot will result.

Cautionary note: Depreciable property used in a §1031 exchange may trigger “depreciation recapture.” For example, if you exchange improved land with a building for unimproved land without a building, any depreciation previously claimed on sold property may be taxable as ordinary income.
TALE #2: A DIFFERENT ANIMAL ALTOGETHER

There are also transactions where owners can “exchange” their interest in real estate for ownership interest in a real estate investment trust (REIT)... kind of... mostly for owners of institutional-grade property.

This particular strategy is more complex and relies on the partnership rules, specifically IRC §721. These exchanges, often called UPREITs (short for “umbrella partnership real estate investment trusts”), can be a real beast compared with the clear-cut nature of a §1031 exchange. UPREITs provide an alternate exit strategy when you wish to get out of direct real estate management and still defer taxes. Instead of selling your property, you contribute it to an UPREIT in exchange for securities known as “operating partnership (OP) units” or “limited partnership (LP) units,” which are worth the same amount as the contributed property.

This initial exchange of real property for partnership units is usually a nontaxable transfer. The owners of LP units also receive an option allowing them to convert their LP units into REIT shares or cash at the REIT’s option. As this normally creates a taxable event for the LP unit holder, most opt to not exercise their options.

The “contribution” of your property to an UPREIT is not automatic. A REIT only accepts property that fits the acquisition criteria for inclusion in its portfolio, usually institutional-grade. To circumvent this issue, owners of property that is not institutional grade can first sell and replace it through a §1031 exchange into a tenancy-in-common (TIC) property investment or acquire UPREIT-grade property.

A notable advantage of an UPREIT transaction is that you essentially convert an interest in one or more specific properties into an interest in a larger and more balanced portfolio of properties, and potentially decrease risk. The operating partnership’s portfolio often benefits from greater diversification in property type and location, as well as from the economies of scale and management that a larger entity can offer.

THE DOWNSIDE OF UPREITS

Because you now own securities rather than the property itself, you can’t change course and move the exchange out of the UPREIT and into other real estate. The sale or disposition of your interest in an UPREIT will result in a taxable transaction, including the recognition of your deferred capital gain and any depreciation recapture. You can, if you wish, convert operating partnership units over time to spread out and lessen the tax impact.

The UPREIT also has control over your asset and can sell or dispose of it. The sale or disposition of the asset can trigger the recognition of your deferred capital gain and any depreciation recapture. Some UPREIT sponsors will guarantee that they will not trigger any taxable gain for a specified number of years, while others remain silent.

That said, enterprising investors have suggested an alternative UPREIT exit strategy that could in theory preclude the recognition of capital gains. The stars would have to align. If
they do, it might look like this: The holder of OP units in an UPREIT identifies real property of a value equal to her OP units, and persuades the REIT to purchase the property and then exchange the new property for the investor's OP units.

ALL ABOUT THAT BASIS
At this point in our tale, we need to emphasize that these strategies, §1031 exchanges and UPREITs, will both lead to the same ending. Eventually, you—or your heirs—can count on a tax bill. Relying on today's numbers, it would amount to a 20% federal capital gains tax, plus 3.8% Medicare tax, plus state tax (maximum of 13.3% in California). On top of this, there may be a depreciation recapture tax.

§1031 EXCHANGE
If you use a like-kind exchange, you must calculate and keep track of your basis in the new property you acquired in the exchange. The basis of property you acquire is the basis of the property you relinquish, with some adjustments. This transfer of basis from one property to another preserves the deferred gain for later recognition. A collateral effect is that the resulting depreciable basis is generally lower than what would otherwise be available if you acquired the replacement property in a taxable transaction. When the replacement property is ultimately sold (not as part of another exchange), the original deferred gain, as well as any additional gain realized since the purchase of the replacement property, is subject to tax.

UPREIT (§721 EXCHANGE)
If OP units in an UPREIT are held for life and included in a taxable estate, the basis in partnership units would be stepped up to current market value when the owner dies, allowing the heirs to convert the partnership units to REIT shares or cash without triggering capital gains tax. UPREITs thus potentially allow owners to transfer appreciated property to heirs tax-free, making this structure a valuable tool for estate planning. As a bonus, UPREIT partnership units may offer more liquidity than real estate to use as a source for paying estate taxes.

IN SUM, FOCUS ON WHAT COUNTS
There’s an old expression, “Don’t let the tail wag the dog.” It refers to people’s tendency to place greater emphasis on the least important aspects of a situation—distracted by the wagging tail of the dog, rather than paying close attention to the dog itself. Don’t allow the tax benefits of any of the transactions outweigh the long-term strategic plans for your assets and family. While each of the transactions discussed have their risks as well as technical requirements, with careful planning and experienced support in place, either can potentially lead to economic rewards.
A Few Words About Vacation Homes

Most people purchase second homes with the expectation of appreciation, but historically there was little to no guidance surrounding what did and did not constitute property held for investment, and thus would be suitable for a §1031 exchange. In 2008, the IRS finally provided a set of clearly defined rules. For a minimum of two years prior to, and after, the exchange:

- You must rent the property for a minimum of two weeks to a non-relative.
- You can rent to a relative as long as it is his or her primary residence and you charge fair market value rent.
- You can use the property personally only for two weeks or 10% of the time rented.
- You can maintain the property for an unlimited period, but you must keep documentation for all of these activities.
- You report the property as “income property” on Schedule E of your tax return.
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