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Insights

Planning Considerations for IRC Section 1031 Exchanges

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The central Indiana commercial real estate market continues to be active, with multi-family and industrial sale activity in particular remaining strong after a better-than-expected 2020 despite the uncertainty created by the COVID-19 pandemic. Industry experts and economists project that, due to the current interest rate environment and market conditions, along with growing optimism that the worst of the COVID-19 pandemic is in the past, commercial real estate transaction activity will remain high for the balance of 2021.

Many owners, even those owners who previously did not intend to sell, are considering selling their real estate to take advantage of the current market conditions. With transactions seemingly becoming quicker each year, it is important for owners to consider many factors when preparing to sell their real estate.

Planning to execute an Internal Revenue Code ("IRC") Section 1031 Exchange (a "1031 Exchange") is often overlooked by owners during the sales planning process. Instead, it is common for owners to wait late into the negotiation of the Purchase Agreement (or worse, after the execution of the Purchase Agreement) to first bring up implementing a 1031 Exchange. The further in a transaction the 1031 Exchange issue is raised, the fewer options owners likely will have on how the 1031 Exchange can be structured.

Before discussing the benefits of advanced 1031 Exchange planning, let's briefly review the basics of a 1031 Exchange. Section 1031 of the IRC provides an exception to the general rule that gain must be recognized on the sale or exchange of real property when certain qualifying property is exchanged for other qualifying property that is like-kind.

By executing a 1031 Exchange, an owner can defer the gain on the sale or exchange of real property by following specific rules, including but not limited to: (1) the properties must be like-kind (see Treas. Reg. Section 1.1031(a)-1(b)); (2) the owner intends to hold the property for productive use in a trade or business or for investment; (3) deadlines for the identification of replacement property and closing on the replacement property transaction are met; and (4) the owner receiving the replacement property is the same as the person who exchanged the relinquished property.

An owner should consult both its legal counsel and CPA to confirm the legal requirements and processes are followed when conducting a 1031 Exchange. In addition, an owner should engage a 1031 Exchange intermediary to facilitate both steps of the 1031 Exchange.

In a standard 1031 Exchange, an owner sells Property A for $1.5 million ($500,000 of which is gain) and then purchases Property B for $3 million. If the owner follows the rules and regulations governing 1031 Exchanges, the $500,000 gain which generally would be recognized for the sale of Property A is shielded from tax.

Most every real estate professional is aware of the standard 1031 Exchange explained above, which can occur as a simultaneous or a delayed exchange. However, owners can also execute reverse 1031 Exchanges where the replacement property is acquired before the relinquished property or an improvement 1031 Exchange where the owner repairs or renovates an existing building or constructs a new building on the replacement property with the cost of the improvements counting towards the exchange value.

Owners will benefit by planning in advance for standard, reverse and improvement 1031 Exchanges. Knowing a 1031 Exchange will be conducted will allow an owner to begin searching for a replacement property and will allow for the owner to make a purchase decision on a replacement property without feeling the pressure of purchasing a replacement property just for 1031 Exchange purposes.

In the event an owner fails to plan in advance for a standard, reverse or improvement 1031 Exchange, by including a standard 1031 Exchange provision in the Purchase Agreement, owners will be protected in most exchange scenarios since the 1031 Exchange will have minimal or no impact on purchaser.

However, failing to plan in advance for a 1031 Exchange may prevent an owner from considering a partnership division in connection with a 1031 Exchange, which is a lesser-known but effective structure which permits certain partners in a partnership to conduct a 1031 Exchange while allowing other partners to cash out.

Section 1031 of the IRC does not permit a 1031 Exchange of partnership interests. A partnership, including a limited liability company treated as a partnership, can conduct a 1031 Exchange if all 1031 Exchange requirements are met. Accordingly, if ABC, LLC wished to sell Property X and purchase Property Y, ABC, LLC could conduct a 1031 Exchange if ABC, LLC is the selling entity of Property X and the purchasing entity of Property Y.

Issues arise when, for example, only two of the three partners of ABC, LLC want to conduct a 1031 Exchange. In that instance, a partnership division can be conducted pursuant to IRC Section 708 and Treas. Reg. Section 1.708-1(d)(3)(i)(A). The mechanics of a partnership division are beyond the scope of this article, but the end result for the above example is the two partners of ABC, LLC who want to conduct a 1031 Exchange will be permitted to do so with the third partner being able to cash out at the closing of the sale of Property X.

Implementing a partnership division will require bespoke language in the Purchase Agreement and will impact the structure of the transaction. As such, it is highly advisable for an owner to solicit input from its counsel and CPA prior to finalizing the LOI in order to put the proper structure in place to execute a partnership division and 1031 Exchange.

Even if an owner does not implement a complex 1031 Exchange strategy, by considering all options prior to entering into an LOI, an owner will put itself in the best position to maximize the tax advantage provided by a 1031 Exchange or make an informed decision that implementing a 1031 Exchange is not in the owner's best interest.

If you have any questions regarding IRC Section 1031 Exchanges, please contact **David A. Adams**, **Christopher Engel**, or a member of the Krieg DeVault LLP **Real Estate & Environmental Practice**.