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Trading Down – §1031 Exchange and the Installment Method

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"By using the installment sales method it is possible to "trade down" in a §1031 exchange and still defer taxes using both §1031 and §453"

In order to avoid taxable "boot", the relinquishing party in a §1031 exchange generally "trades up" – that is, the replacement property has a higher value than the relinquished property. However, using the installment sales method (under §453(f)(6) of the Internal Revenue Code) it is possible to "trade down" and still defer taxes using both §1031 and §453.

Consider the following examples:

Example 1. A owns real property with a fair market value of $1,000. A's basis is $400. On December 1, 2012, A transfers the property to a qualified intermediary (QI) who transfers it to B for $1,000. On February 1, 2013, the QI acquires replacement property with a fair market value of $800 and delivers the replacement property and $200 to A. As a result of the transaction, A has $200 in boot which is not recognized until 2013. A takes a $400 basis in the replacement property.

Example 2. Same facts as in Example 1, except that B pays $800 in cash and the remaining $200 is financed by A under a four-year installment note. When the QI acquires the replacement property, the QI transfers the property and the note to A. As a result of the transaction, A still has $200 in boot, but A recognizes $50 in 2013, 2014, 2015 and 2015, and takes a $400 basis in the replacement property.

Example 3. A owns real property with a fair market value of $1,000. A's basis is $200. On December 1, 2012, A transfers the property to a qualified intermediary (QI) who transfers it to B for $1,000, of which $400 is paid in cash, and the remaining $600 is financed by A under a six-year installment note. On February 1, 2013, the qualified intermediary acquires replacement property with a fair market value of $400 and delivers the replacement property and the installment note to A. As a result of the transaction, A has $600 in boot of which $100 is recognized in 2013, 2014, 2015, 2016, 2017, and 2018. A takes a $200 basis in the replacement property.

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Locking in Your Prop. 8 Tax Rate

I've written elsewhere about the relationship between Propositions 13 and 8. To summarize, Proposition 13 limits property tax increases to 2% per year. Thus, if property values rise 10% in one year, the assessed value will not increase more than 2%.

Proposition 8 deals with the flip side of the coin – declining values. Under Proposition 8, if your property value declines, the assessed value declines to the reduced fair market value. There is no limit to the decline in value assessment. Thus, if the property value declines 10% in one year, the assessed value will decline 10%.

Once you are under Proposition 8, your assessed value can increase the following year or years if the market value increases. Thus, if your assessed value is reduced 10% in Year 1, it can be increased 10% the following year if the values rise. The only limitation to the increase is the original Proposition 13 limit.

Because the original (and higher) Proposition 13 value is the only limit to increases following a decline in value assessment, there can be tremendous benefit to "locking in" your Proposition 8 value.

How can you do this? Paradoxically, by purposefully triggering a transfer – something tax planners ordinarily spend a considerable amount of time avoiding.

This can be done in any number of ways. For example, assume the property is owned by ACB, LLC and has two 50% members, D and E. ABC, LLC can do a non-proportional transfer to a new entity owned by D, 49%, E 49% and F 2%. This can be especially beneficial for estate planning purposes (e.g., entity owned by husband and wife transfers ownership to new entity owned by husband, wife and child). Or one of the members can transfer a 1% interest to F, thereby reducing their economic interest below 50%. Or, D can transfer economic or voting control to E by transferring a 1% economic or voting interest. There are many possibilities. If you property is in Proposition 8 status, you may want to consider them.

"How can you lock in your Proposition 8 Value? Paradoxically, by purposefully triggering a transfer – something tax planners ordinarily spend a considerable amount of time avoiding.'"

Totally unrelated to the law, as an avid cyclist, I've decided to use these pages to showcase some of the highlights of recent bike rides. This photo shows a section of mountain bike single-track on the "Flynn Ranch" in the spring.

Pitfalls of Options to Renew

Many commercial leases give the tenant one or more options to renew. If your lease contains such an option, it is important be aware of any conditions to the exercise of the option, including any time restraints. Given the very strict construction given to options by the courts, even minor failures to strictly comply with the terms of the option can result in the loss of the option.

Time Constraints. Options to renew generally come with time constraints. For example, a lease may provide that the option can be renewed not more than six months, or less than three months prior to the expiration of the initial lease term. Failure to timely comply with the notice provisions may result in a loss of the option to renew. In one case, the tenant was required to provide notice of its intent to exercise the option no less than six months before the expiration of the term. The tenant, after making substantial improvements to the premises and to an adjacent building in reliance upon the continuation of the lease, gave notice four months before the expiration term. The court held that the tenant had failed to satisfy a condition to the exercise of the option (timely notice), and even refused to enforce the option on equitable grounds to avoid a forfeiture.

This photo shows an exposed section of the 90-year-old "Gordon Line" just south of Lake Curry. The Gordon Line once transported large quantities of water from Lake Curry to the City of Vallejo. Today, water is reverse fed up the Gordon Line to serve a few end users in Gordon Valley.

Other Conditions - No Default. Options to renew also generally require that the tenant not be in default when the option is exercised. For example, the lease may provide that "so long as tenant is not in default when the option is exercised, tenant will have one option to renew." Clever landlords who wish to get out of a lease will often rely on seemingly minor defaults in order to not honor the exercise of an option. Given the strict construction given to option conditions, courts will generally enforce this, even for seemingly minor defaults. To give an example of this strict construction, in one case, a tenant had been cited for a fire code violation. The court held that the tenant's exercise of option was invalid even though the landlord did not even know of the alleged fire code violation at the time it refused to honor the tenant's purported exercise of the option.

"Given the very strict construction given to options, even minor failures to strictly comply with the terms of the option can result in the loss of the option."

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What general principals can be derived from these examples?

1. Money or an installment note deposited with a qualified intermediary that is otherwise boot is not constructively received until the end of the exchange period. (The same rule applies in deferred exchanges where the buyer places the purchase price in a qualified escrow and acquires the replacement property for the relinquishing party.) Thus, if the closing of the relinquished and replacement properties occurs in separate tax years, taxable boot may deferred to the year in which the replacement property closes.

2. The basis in the relinquished property carries over to the replacement property. As a result, normal §453 "gross profit percentage rules" do not apply. Under normal installment sale rules, a portion of each payment is recognized as income and a portion is treated as a return of basis. When the installment method is combined with a §1031 exchange, all payments under the note are treated as taxable (because all of the basis carries over to the replacement property).

3. Using the installment method, taxable boot resulting from the exchange may be deferred over the period of the installment note.

What is the Real Effect of an "AS IS" Clause

I often hear real estate brokers, attorneys and even judges hype the importance of "as is" clauses found in most purchase agreements. A typical "as is" clause provides that the buyer agrees to "acquire the property 'AS IS' and with all faults."

But what legal effect, if any, does an "as is" clause really have? If you listen to your average broker or plaintiff's real estate attorney, you might think an "as is" clause dramatically alters the relationship between seller and buyer in favor of the seller. It does not. In fact, I would suggest that an "as is" clause legally adds *nothing* to a purchase agreement.

An "as is" clause means that the seller is not making any representations or warranties with respect to the condition of the property. But this is the *default* rule in California.

Please see, *As–Is Clause, next column*

Flynn-Law Press

The *Green Valley Landowners Association v. City of Vallejo* water class action litigation continues to generate a considerable amount of press, this time in the form of community letters to the editor:

http://www.dailyrepublic.com/opinion/letters-editor/cynical-disregard-for-people/

http://www.dailyrepublic.com/opinion/letters-editor/repair-our-water-system/

http://www.dailyrepublic.com/opinion/letters-editor/shame-on-vallejo-for-lakes-water-system/

http://www.dailyrepublic.com/opinion/letters-editor/treatment-of-lakes-systems-customers-shameful/

http://www.dailyrepublic.com/opinion/letters-editor/arguments-for-water-rate-increase-are-ridiculous/

http://www.dailyrepublic.com/opinion/letters-editor/water-costs-more-than-health-care/

As–Is Clause, continued

Under Civil Code §1113, only two representations . are implied by law -- (1) that the seller has not previously sold the property (or any right or interest therein), and (2) that the property is free from encumbrances. There are *no other* implied covenants. In other words, unless modified by agreement, all sales of real property are "as is" as a matter of law.

So, what matters is not whether the sale is or is not *expressly* "as is." What matters are the express representations and warranties the seller is actually making in the purchase agreement. For example, a purchase agreement which limits the seller's representations to those found in Civil Code §1113 is as close to an "as is" sale as you can find – *regardless* of whether or not there is an "as is" clause. On the other hand, a purchase agreement which contains an "as is" clause, but where the seller makes 35 different representations and warranties is a far, far cry from a true "as is" sale.

With that being said, do I include "as is" provisions in my purchase agreements when I represent the seller? Absolutely. Why? As long as many brokers, attorneys and judges continue to believe that an "as is" provision somehow alters the seller-buyer relationship, I am going to include it. So while I include the "as is" for whatever marginal or perceived effect it may have, I devote my time and attention to the representations expressly included in the purchase agreement, and not to the presence or absence of an "as is" clause.

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