Section 1031 - Tax Deferred Exchanges: 'Real Estate's Best-Kept Secret for Tax Relief'

by Joel Rosenfeld, CRE

One of the least understood tax relief provisions of the Internal Revenue Code (IRC) is the tax-deferred exchange under Section 1031 of the IRC. Although the tax shelter days are basically gone for real estate investors, and the passive loss regulations work against them, the tax-deferred exchange lives on as a viable and excellent alternative to defer income taxes upon the sale of real estate.

An exchange is broadly defined as a reciprocal transfer of real property that has certain tax advantages over a sale. Definite procedures must be followed in order to qualify the transfer as an exchange.

The choice of a tax-deferred exchange affords the seller/taxpayer an exceptional opportunity upon selling the property. A tax-deferred exchange can best be defined as a sale without immediate tax implications with a window to replace the property with like-kind property and reduce the basis of the replacement property by the deferred gain, thereby deferring the tax to a future date.

Included here is a series of questions and answers that will help explain how tax-deferred exchanges work:

WHAT IS THE DIFFERENCE BETWEEN A SIMULTANEOUS EXCHANGE AND A DEFERRED EXCHANGE?

Once the provisions of the tax-deferred exchange are understood, the process is perhaps more mechanical and form oriented. The misconception of tax-deferred exchanges lies with the thought and confusion that

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properties must be "swapped" simultaneously. For example, property owner "A" wishes to exchange an office building with property owner "B" who is looking to sell an office building. If both parties agree to exchange their properties, they have entered into a *simultaneous exchange*. In reality, the simultaneous exchange rarely occurs because of the complications of the identifying process, the timing, and establishing values. A tax-deferred *exchange*, however, affords the seller a time frame in which to sell the property ("the relinquished property"); seek other property ("the replacement property"); and comply with the provisions of Section 1031 of the IRC. In essence, a deferred exchange can qualify for deferral of taxable gain under Section 1031 of the IRC even if there is a time frame between the seller's transfer of the relinquished property and the purchase of the replacement property. As a result of the time parameters and the available options for selecting the replacement property, the tax-deferred exchange is one of the few remaining tax shelters for real estate owners and investors.

HOW MANY REPLACEMENT PROPERTIES MAY THE SELLER IDENTIFY?

When seeking replacement property, it is advantageous to identify more than one property in the event that the primary property cannot be acquired. The regulations provide that the seller must meet **any one** of the following three alternatives for property identification:

- One to three properties without regard to the fair market value.
- Any number of properties, provided that the aggregate fair market value does not exceed 200 percent of the relinquished property.
- Any number of properties as long as the acquisition of the replacement property represents 95 percent of the identified properties. (*e.g.*, If you identify $2,000,000 in replacement property and purchase $1,900,000.)

Of the three alternatives, the "three property rule" is the one most sellers choose.

WHAT IS "LIKE-KIND" PROPERTY?

What qualifies as a like-kind property exchange is much broader than what many property owners may believe. The physical similarity of the properties, such as an office building for an office building, is not important. The tax regulations simply state that real property must be exchanged for real property. The purpose and intent (investment) of the taxpayer takes precedence. The following examples illustrate some qualified like-kind property exchanges:

- An office building for a shopping center
- A shopping center for land
- Land for an industrial building
- A fee simple for a tenancy-in-common
- An industrial building for a multi-family property

Due to the broad definition of like-kind property, the identification of replacement property is easily facilitated. Under no circumstances, however, may real estate be exchanged for a limited or general partnership interest of an entity which holds real estate or for stock in a corporation that holds real estate (such as a REIT).

WHAT AND WHO IS A QUALIFIED INTERMEDIARY?

A qualified intermediary (QI) is an individual or an entity that theoretically acquires the seller's relinquished property, and ultimately resells it to the buyer. The QI will acquire the replacement property and transfer the replacement property to the seller. It is the QI who facilitates the tax-deferred exchange.

The use of a QI is mandatory when entering into a tax-deferred exchange. The selection of a QI that is knowledgeable about Section 1031 will greatly facilitate the process.

One, however, must be very cautious in the selection, as the QI must meet the qualifications established by the tax regulations. The QI must not be the seller, or a "disqualified person." For purposes of a tax-deferred exchange, a disqualified person is a person or an entity that acts as a seller. This includes those who fill any of the following roles:

- Employee
- Attorney or accountant
- Real estate broker
- Any related party (as defined by IRC 267(b) or 707(b) family members, related corporations, etc.)

It is imperative that a seller seeks out an acceptable QI, such as a title company, a financial institution, a trust, or an escrow service company. For unexplained reasons, Section 1031 Exchanges are entered into more frequently on the West Coast than the East Coast. As a result, there appears to be a greater selection of very capable QIs in the West.

There is a misconception in the use of a QI for the mechanical transfer of the property. Under "direct deeding" of the relinquished property, the seller deeds the property to the ultimate buyer (not the QI). Furthermore, the owner of the replacement property directly deeds the property to the seller (not the QI). Hence, the transactions are completed without the QI ever taking title to the relinquished or replacement property.

The following example demonstrates how a gain is deferred on the sale of property:

Seller ("X") owns an office building that he desires to sell, and prefers to defer the gain.

Land	$600,000
Building	$3,000,000
Improvements	$100,000
	$3,700,000
Less: Accumulated depreciation	(900,000)
Adjusted basis	$2,800,000
Mortgage on property	$1,500,000
Selling price	$3,500,000

If "X" sells the property, and does not enter into a tax-deferred exchange, he will realize and recognize a taxable gain as follows:

Sales price	$3,500,000
Adjusted basis	$2,800,000
Gain	$700,000
Tax on sale *	x 25%
Tax liability	$175,000

** According to the 1997 Tax Act, the tax of 25 percent is based on $700,000 of depreciation recapture.*

If "X" enters into a tax-deferred exchange by identifying like-kind property within 45 days, and closes within the 180-day period, the tax on the gain would be deferred as follows:

Replacement property purchase price	$3,800,000
Cash down payment	$1,000,000
Assumed debt	$2,800,000

Since equity was replaced with equity and debt was replaced with other debt, and the replacement property acquisition price of $3.8 million exceeds the

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$3.5 million of relinquished property, "X" receives no net boot. The entire gain of $700,000 is tax-deferred. The basis of the replacement property is adjusted as follows:

Replacement property acquired	$3,800,000
Gain not recognized	($700,000)
New basis in replacement property	$3,100,000

By completing the tax-deferred exchange, "X" has successfully deferred a gain of $700,000 and a tax liability of $175,000.

CAN YOU COMPLETE A TAX-DEFERRED EXCHANGE WITH RELATED PERSONS?

Very often when property is sold and the requirement for replacement property needs to be completed, the seller would prefer to use property already owned as the replacement property. An exchange between related persons can qualify for non-recognition treatment under IRC 1031.

A definition of "Related Persons" is described in IRC 267(b) and IRC 707(b) as follows:

1. Family members (siblings, spouse, ancestors, and lineal descendants)
2. Individual and corporation, where more than 50 percent in value of the stock is owned directly or indirectly by or for such individual
3. Two corporations that are part of the same control group
4. A grantor and a fiduciary of the same trust
5. A fiduciary and beneficiary of the same trust
6. A fiduciary of a trust and the fiduciary or beneficiary of another trust where the same person is

the grantor of both trusts

7. A fiduciary of a trust and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for the trust or by or for the grantor of the trust
8. A person and an IRC Section 501 organization - if the organization is controlled by that person or that person's family
9. A corporation and a partnership if the same persons own more than 50 percent in value of the outstanding stock of the corporation and more than 50 percent of capital interest or profits interest in the partnership
10. An S Corporation and another S Corporation or a C Corporation if the same person own more than 50 percent of the value of the outstanding stock of each corporation
11. A partnership and a person owning, directly or indirectly, more than 50 percent of the capital interest, or profits interest, in such partnership
12. Two partnerships in which the same persons own, directly or indirectly, more than 50 percent capital interests or profits interests
13. An executor of an estate and the beneficiaries of the estate

If property is exchanged with a related person, and the property is disposed of by the related person or the taxpayer of the property, either one received in the exchange within two years of the date of transfer, the gain or loss must be reported. The two-year holding period is critical in order to sustain the tax-deferred exchange. There are certain exceptions to the two-year holding period, but they are too numerous to discuss for the purposes of this article.

The Internal Revenue Service ("IRS") will carefully scrutinize related party transactions to identify tax avoidance schemes. If the related party transaction is an "arms length" exchange and tax avoidance is not the motive, the related party exchange should work.

WHAT HAPPENS IF THE PARTIES DISAGREE ABOUT COMPLETING A TAX-DEFERRED EXCHANGE?

It is not uncommon when a partnership sells its property, the partners may elect to go their separate ways. Still, many desire to use IRC 1031 to tax defer the tax impact of a gain. The split-up of the partnership and the utilization of IRC 1031 can be structured as follows:

If the partners want to split-up:

The partnership can dissolve, and distribute the property ownership pro-rata into a tenancy-in-common. Under IRC 731, distributions of partnership property is deemed tax-free. Subsequent to the receipt of an undivided interest in the property, each co-tenant may exchange his real property interest for another property interest.

If the partners want to continue their relationship:

Each partner can identify a separate replacement property, allowing the partnership to exchange its property for specific replacement properties. After taking title to the replacement properties, the partnership may distribute the properties in a tax-free liquidation of the partners interest.

Depending on the desires of the partners, another option available is the designation of property by each partner, whereby the partnership exchanges its property for the designated property. They will then continue to operate with special allocations of the income or losses to each respective partner.

WHAT HAPPENS IF THE REPLACEMENT PROPERTY IS IDENTIFIED BEFORE THE SALE OF THE RELINQUISHED PROPERTY?

In certain situations, it is likely that a taxpayer may identify the replacement property before the relinquished property is sold. If the seller of the replacement property is willing to extend the closing date in order to sell the property, then a deferred exchange can be completed. If the seller does not agree to an extension of the closing date, the taxpayer may use a *reverse exchange*.

By entering into a reverse exchange, an unrelated third party to the exchanger acquires and holds the replacement property. This is known as "parking" the property.

The selection of the unrelated third party is often the QI, who will park the property until the seller disposes of it. At that time, the QI will assist in the completion of the exchange by conveying the replacement property to the seller.

There has been some question as to the use of the parking method. Until recently, the IRS had reserved judgment as to whether Section 1031 applies if the replacement property is acquired before the relinquished property is transferred. Recently, however, the IRS issued Revenue Procedure 2000-37, which provides a Safe Harbor for a taxpayer engaging in the parking of property. The regulation cites a). the qualification of property as "replacement property" or "relinquished property"; and b). the

acceptance of the QI as the beneficial owner of the property for federal income tax purposes (as long as the property has been acquired on or after September 15, 2000). As a result of this, we can anticipate that taxpayers may engage in more reverse exchanges.

CAN A REFINANCE OCCUR *PRIOR* TO EXCHANGING AND *SUBSEQUENT* TO EXCHANGING?

Pre-Exchange Refinancings

The current position of authority states that where a pre-exchange refinancing is completed as part of an exchange transaction, the cash received by a taxpayer from the refinancing will be treated as cash ("boot") received on the disposition of the relinquished property. And consequently, the boot will be taxable.

Post-Exchange Refinancings

If the taxpayer completes a post-exchange refinance, there should be less concern for tax purposes than a pre-exchange refinance. Thus, if a taxpayer refinances property immediately upon taking title, receipt of the cash will not be treated as boot and will not be taxable.

The theoretical difference between the pre- and post-exchange lies with the concept of repayments of the debt. In a post-exchange refinancing, the taxpayer has the responsibility for repayment of the debt, whereas the taxpayer in a pre-exchange refinancing is relieved of the liability upon the transfer of the relinquished property.

CONCLUSION

Sellers should view tax-deferred exchanges as a viable tax planning tool. Properly structured tax-deferred exchanges can defer significant gain and the corresponding tax liabilities. Most important to remember is that sellers do not have to enter into a simultaneous exchange which, more often than not, is nearly impossible to effectuate. Tax-deferred exchanges under Section 1031 of the IRS code allow taxpayers a reasonable period of time in which to complete a tax-deferred transaction. REI25

GLOSSARY OF KEY TERMS

- **Adjusted basis** - the basis of the property, plus any improvements, reduced by any depreciation taken on the property
- **Basis -** the seller's original cost of the property (before depreciation)
- **Boot** - any considerations (cash or property) received other than real property. It does not qualify under Section 1031 and may be taxable
- **Deferred Exchange** - an exchange qualifying for non-recognition of gain, whereby the sold property (relinquished property) is replaced (replacement property) within the statutory time, as provided by the IRC
- **Exchange Period** - date that seller must close on the replacement property before the earlier of 1). 180 days after the transfer of the relinquished property; or 2). the due date of the seller's federal income tax return (including extensions) for the year in which the relinquished property is transferred
- **Identification Period** - begins on the date the seller transfers the relinquished property and ends on midnight of the 45th day thereafter
- **Parking** – term used to refer to the holding of a replacement property by an unrelated third party in the case of a reverse exchange
- **Qualified Intermediary (QI)** - a person or entity that acquires the replacement property for the seller in exchange for the seller's relinquished property
- **Realized gain** - the difference between the sale price (cash and other property), and the adjusted basis
- **Recognized gain** - that portion of the realized gain that is taxable
- **Relinquished property** - the property that the seller disposes of in the exchange
- **Replacement property** - the like-kind property the seller acquires in the exchange
- **Reverse exchange** – strategy used by the seller to complete a deferred exchange whereby an unrelated third party acquires and holds the replacement property until the relinquished property can be sold.