

The Basic Rules For A 1031 Exchange

The Exchange Property Must Be Qualifying Property. Qualifying property is property (or equipment) held for investment purposes or used in a taxpayer's trade or business. Investment property includes real estate, improved or unimproved, held for investment or income producing purposes. Property used in a taxpayer's trade or business includes his office facilities or place of doing business, as well as equipment used in his trade or business.

Property Which Does Not Qualify For A 1031 Exchange includes ?

- A personal residence
- Land under development
- Construction or fix/flips for resale
- Property purchased for resale
- Inventory property
- Corporation common stock
- Bonds
- Notes
- Partnership interests

As explained below, common stock may (or may not) include ditch stock which is sold with farm land.

Replacement Property Title Must Be Taken In The Same Names As The Exchange Property Was Titled.

The Replacement Property Must Be Like-Kind. For real estate exchanges, like-kind replacement property means any improved or unimproved real estate held for income, investment or business use. Improved real estate can be replaced with unimproved real estate. Unimproved real estate can be replaced with improved real estate. A 100% interest can be exchanged for an undivided percentage interest with multiple owners and vice-versa. One property can be exchanged for two or more properties. Two or more properties can be exchanged for one replacement property. A duplex can be exchanged for a four-plex. Investment property can be exchanged for business property and vice versa. However, as referenced above, a taxpayer's personal residence cannot be exchanged for income property, and income or investment property cannot be exchanged for a personal residence, which the taxpayer will reside in.

Any Boot Received In Addition To Like Kind Replacement Property Will Be Taxable (to the extent of gain realized on the exchange). This is okay when a seller desires some cash or debt reduction and is willing to pay some taxes. Otherwise, boot should be avoided in order for a 1031 Exchange to be completely tax-free.

The term "boot" is not used in the Internal Revenue Code or the Regulations, but is commonly used in discussing the tax consequences of a Section 1031 tax-deferred exchange. Boot received is the money or the fair market value of "other property" received by the taxpayer in an exchange. Money includes all cash equivalents plus liabilities of the taxpayer assumed by the other party, or liabilities to which the property exchanged by the taxpayer is subject. "Other property" is property that is non-like-kind, such as personal property received in an exchange of real property, property used for personal purposes, or "non-qualified property." "Other property" also includes such things as a promissory note received from a buyer (Seller Financing).

A Rule Of Thumb for avoiding "boot" is to always replace with property of equal or greater value than the Exchange Property. Never "trade down." Trading down always results in boot received, either cash, debt reduction or both. Boot received is mitigated by exchange expenses paid. See *The Rules Of Boot In A Section 1031 Exchange* for a detailed explanation of these rules.

The Basic Types Of Exchanges

A Simultaneous Exchange is an exchange in which the closing of the Exchange Property and the Replacement Property occur on the same day, usually back - to - back. There is no interval of time between the two closings. This type of exchange is covered by the Safe Harbor Regulations.

A Delayed Exchange is an exchange where the Replacement Property is closed on at a later date than the closing of the Exchange Property. The exchange is not simultaneous or on the same day. This type of exchange is sometimes referred to as a "Starker Exchange" after the well known Supreme Court case in which ruled in the taxpayer's favor for a delayed exchange before the Internal Revenue Code provided for such exchanges. There are strict time frames established by the Code and Regulations for completion of a delayed exchange, namely the 45-Day Clock and the 180-Day Clock (see detailed explanation below). Delayed exchanges are covered by the Safe Harbor Regulations.

A Reverse Exchange (Title-Holding Exchange) is an exchange in which the Replacement Property is purchased and closed on before the Exchange Property is sold. Usually the Intermediary takes title to the Replacement Property and holds title until the taxpayer can find a buyer for his Exchange Property and close on the sale under an Exchange Agreement with the Intermediary. Subsequent to the closing of the Exchange Property (or simultaneous with this closing), the Intermediary conveys title to the Replacement Property to the taxpayer. The IRS has issued new safe-harbor guidance on Reverse Exchanges.

An Improvement Exchange (Title-Holding Exchange) is an exchange in which a taxpayer desires to acquire a property and arrange for construction of improvements on the property before it is received as Replacement Property. The improvements are usually a building on an unimproved lot, but also include enhancements made to an already improved property in order to create adequate value to close on the Exchange with no boot occurring. The Code and Regulations do not permit a taxpayer to construct improvements on a property as part of a 1031 Exchange after he has taken title to property as Replacement Property in an exchange. Therefore, it is necessary for the Intermediary to close on, take title and hold title to the property until the improvements are constructed and then convey title to the improved property to the taxpayer as Replacement Property. Improvement Exchanges are done in the context of both Delayed Exchanges and Reverse Exchanges, depending on the circumstances. The IRS has issued new safe-harbor guidance on Reverse Exchanges (including title-holding exchanges for construction or improvement)

Delayed Exchanges - The Exchange Process And Time Clocks

A taxpayer desiring to do a 1031 Exchange lists and/or markets his property for sale in the normal manner without regard to the contemplated 1031 Exchange. A buyer is found and a contract to sell the property is executed. Accommodation language is usually placed in the contract securing the cooperation of the buyer to the seller's intended 1031 Exchange, but such accommodation language is not mandatory.

When contingencies are satisfied and the contract is scheduled for a closing, the services of an Intermediary are arranged for. The taxpayer enters into an Exchange Agreement with the Intermediary which permits the Intermediary to become the "substitute seller" in accordance with the requirements of the Code and Regulations.

The Exchange Agreement usually provides for:

- An assignment of the seller's Contract to Buy and Sell Real Estate to the Intermediary.
- A closing where the Intermediary receives the proceeds due the seller at closing.
- Direct deeding is used. The Exchange Agreement will comply with the requirements of the Code and Regulations wherein the taxpayer can have

no rights to the funds being held by the Intermediary until the exchange is completed or the Exchange Agreements terminates. The taxpayer "cannot touch" the funds.

- An interval of time where the seller proceeds to locate suitable replacement property and enter into a contract to purchase the property. The interval of time is subject to the 45-Day and 180-Day rules.
- An assignment of the contract to purchase replacement property to the Intermediary.
- A closing where the Intermediary uses the exchange funds in his possession and direct deeding to acquire the replacement property for the seller.

The 45-Day Rule for Identification. The first timing restriction for a delayed Section 1031 exchange is for the taxpayer to either close on Replacement Property or to identify the potential Replacement Property within 45 days from the date of transfer of the exchanged property. The 45-Day Rule is satisfied if replacement property is received before 45 days has expired. Otherwise, the identification must be by written document (the identification notice) signed by the taxpayer and hand-delivered, mailed, faxed, or otherwise sent to the Intermediary. The identification notice must contain an unambiguous description of the replacement property. This includes, in the case of real property, the legal description, street address or a distinguishable name.

After 45 days, limitations are imposed on the number of potential Replacement Properties which can be received as Replacement Properties. More than one potential replacement property can be identified under one of the following three conditions:

The Three-Property Rule - Any three properties regardless of their market values.

The 200% Rule - Any number of properties as long as the aggregate fair market value of the replacement properties does not exceed 200% of the aggregate FMV of all of the exchanged properties as of the initial transfer date.

The 95% Rule - Any number of replacement properties if the fair market value of the properties actually received by the end of the exchange period is at least 95% of the aggregate FMV of all the potential replacement properties identified.

Although the Regulations only require written notification within 45 days, it is recommended practice for a solid contract to be in place by the end of the 45-day period. Otherwise, a taxpayer may find himself unable to close on any of the properties which are identified under the 45-day letter. **After 45 days have**

expired, it is not possible to close on any other property which was not identified in the 45-day letter. Failure to submit the 45-Day Letter causes the Exchange Agreement to terminate and the Intermediary will disburse all unused funds in his possession to the taxpayer.

The 180-Day Rule for Receipt of Replacement Property. The replacement property must be received and Exchange completed no later than the earlier of 180 days after the transfer of the exchanged property or the due date (with extensions) of the income tax return for the tax year in which the exchanged property was transferred. The replacement property received must be substantially the same as the property which was identified under the 45-day rule described above. There is no provision for extension of the 180 days for any circumstance or hardship.

As noted above, the 180-Day Rule is shortened to the due date of a tax return if the tax return is not put on extension. For instance, if an Exchange commences late in the tax year, the 180 days can be later than the April 15 filing date of the return. If the Exchange is not complete by the time for filing the return, the return must be put on extension. Failure to put the return on extension can cause the replacement period for the Exchange to end on the due date of the return. This can be a trap for the unwary.

Reverse Exchanges - The Exchange Process And Time Clocks

After promising to do so since 1991, the IRS issued safe-harbor guidance and recognition for Reverse Exchanges on September 15, 2000. Rev. Proc. 2000-37 officially sanctions Reverse Exchanges that are structured to comply with the procedures outlined in the Revenue Procedure. The new safe-harbors are effective for Reverse Exchanges occurring on or after September 15, 2000.

Reverse Exchanges occur when a taxpayer arranges for a Exchange Accommodation Titleholder (EAT) (usually the Intermediary) to take and hold title to Replacement Property before a taxpayer finds a buyer for his Exchange Property. Sometimes the exchange accommodation titleholder will take and hold title to the Exchange Property until a buyer can be found for it. Reverse Exchanges have been common and have been preferred in circumstances where a taxpayer has been compelled to close on Replacement Property before an Exchange Property could be sold and closed or where the taxpayer desired ample time to search for suitable Replacement Property before selling an Exchange Property which started the well-known 45 and 180-day clocks for Delayed Exchanges.

Reverse Exchanges have also been common where a taxpayer wanted to

acquire a property and construct improvements on it before taking title to the property as Replacement Property for an exchange. The Reverse Exchange gave the taxpayer extra time to get the improvements constructed in addition to the 180-day clock referred to above.

The new safe-harbor procedures impose compliance requirements on Reverse Exchanges that are new and require analysis for impact and planning that can be summarized as follows ?

- **The 5-Day Rule.** A "Qualified Exchange Accommodation Agreement" must be entered into between the taxpayer and the exchange accommodation titleholder (qualified intermediary in most cases) within five business days after title to property is taken by the exchange accommodation titleholder in anticipation of a Reverse Exchange.
- **The 45-Day Rule.** The property to be "relinquished" (the exchange property) must be identified within 45-days. More than one potential property to be sold can be identified in a manner similar to the rules of delayed exchanges (i.e., the three-property rule, the 200% rule, etc.)
- **The 180-Day Rule.** The Reverse Exchange must be completed within 180-days of taking title by the exchange accommodation titleholder.

The 180-Day Clock? As with Delayed Exchanges where the exchange must be completed within 180-days, Reverse Exchanges now must be closed under the new procedures within 180-days. This is a new requirement. In the past, since there has been no statutory limitation of time in which to be in title, it has been common for the Exchange Accommodation Titleholder to be in title on the parked property for a year or more during which the taxpayer would find a buyer for his Exchange Property or during which time the taxpayer would have improvements constructed on the property being held by the Titleholder.

180-days may be a suitable time for a buyer to be found for the Exchange Property. But, 180-days is a problem with respect to construction/improvement exchanges. The 180-day time limit within which to complete a safe-harbor Reverse Exchange is probably insufficient for most large "build to suit" exchanges.

What if the taxpayer has not yet found a buyer for his Exchange Property by the end of 180-days? In this case, the taxpayer can discontinue his attempt to accomplish a Reverse Exchange and take deed to the Replacement Property. Or the taxpayer may decide to extend his Reverse Exchange outside of the protection of the safe-harbor procedures. The safe-harbor guidance issued by the IRS is optional, not mandatory. Reverse Exchanges that do not comply with the requirements of Rev. Proc. 2000-37 stand or fall on their own merits and

should be considered risky now that guidelines have been issued for safe-harbor exchanges.

Rev. Proc. 2000-37 imposes new responsibilities and burdens on the Exchange Accommodator Titleholder. The Accommodator is now required to report for federal income tax purposes the "tax attributes" of ownership of the property it is in title on. It is possible that the Accommodator will be required to depreciate the property just as a true owner would be required to do. Rents and expenses attributed to ownership of the property may have to be reported by the Accommodator. There has been no specific requirement requiring Accommodators to do this prior to Rev. Proc. 2000-37.

Failure to comply with these new reporting requirements by the Accommodator could invalidate the safe-harbor protection to the client. In addition to these new responsibilities, Accommodators will now have to track the new "time clocks" that apply to Safe Harbor Reverse Exchanges.

Compliance with these new requirements and responsibilities will impose new administrative burdens and responsibilities on the Accommodator and may contribute to increased fees for this service.

Reverse Exchanges may very well become the preferred way to manage and transact 1031 Exchanges as a result of this new official blessing by the IRS. The 45-Day identification period of Delayed Exchanges and related pressure to find suitable replacement property are often so burdensome that taxpayers are unable to successfully take advantage of the tax-deferral potential of a delayed 1031 exchange. The risks of Reverse Exchanges have been mitigated into reasonable commercial risks with the new safe-harbor guidelines.

The Role Of The Qualified Intermediary

The role of the Qualified Intermediary is essential to completing a successful and valid delayed exchange. The Qualified Intermediary is the glue that puts the buyer and seller of property together into the form of a 1031 Exchange. Where such an intermediary (often called an exchange facilitator) is used, the intermediary will not be considered the agent of the taxpayer for constructive receipt purposes notwithstanding the fact that he may be an agent under state law and the taxpayer may gain immediate possession of the money or property under the laws of agency.

In order to take advantage of the qualified intermediary "safe harbor" there must be a written agreement between the taxpayer and intermediary expressly limiting

the taxpayer's rights to receive, pledge, borrow or otherwise obtain the benefits of the money or property held by the intermediary.

A qualified intermediary is formally defined as a person who is not the taxpayer or a disqualified person who enters into a written agreement (the "exchange agreement") with the taxpayer and, as required by the exchange agreement, acquires the relinquished property from the taxpayer, transfers the relinquished property, acquires the replacement property, and transfers the replacement property to the taxpayer. The qualified intermediary does not actually have to receive and transfer title as long as the legal fiction is maintained.

The intermediary can act with respect to the property as the agent of any party to the transaction and further, an intermediary is treated as entering into an agreement if the rights of a party to the agreement are assigned to the intermediary and all parties to the agreement are notified in writing of the assignment on or before the date of the relevant transfer of property. This provision allows a taxpayer to enter into an agreement for the transfer of the relinquished property (i.e., a contract of sale on the property) and thereafter to assign his rights in that agreement to the intermediary. Providing all parties to the agreement are notified in writing of the assignment on or before the date of the transfer of the relinquished property, the intermediary is treated as having entered into the agreement and, upon completion of the transfer, as having acquired and transferred the relinquished property.

There are no licensing requirements for Intermediaries. They need merely be not an unqualified person as defined by the Internal Revenue Code in order to be qualified. The Code prohibits certain "agents" of the taxpayer from being qualified. Accountants, attorneys and Realtors who have served taxpayers in their professional capacities within the prior two years are disqualified from serving as a Qualified Intermediary for a taxpayer in an exchange.