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Field guide to 1031 Exchanges

There are a number of tax benefits to owning investment property, one of the most important being Internal Revenue Code ß1031. This allows you to avoid paying tax on your gain by exchanging it for like-kind property. Here are some of the more common questions encountered in 1031 exchanges of real estate.

1. What is a tax-deferred exchange?

As a general rule, when an investment is liquidated, the selling party owes tax on the gain on the sale – the amount by which the selling price exceeds the seller's original cost. By using a 1031 exchange, the tax on the gain is deferred until some future date when the newly acquired property is sold, or it's deferred permanently if sold upon inheritance by a beneficiary.

ß1031 of the Internal Revenue Code provides that no gain or loss shall be recognized on the exchange of property *held for* investment purposes or for productive use in a trade or business. Provided the proper steps are taken, a property owner has the ability to defer tax when one or more relinquished properties are exchanged for one or more "like-kind" replacement properties.

2. Are there multiple types of tax-deferred exchanges?

Yes, there are multiple types of exchanges, including the following:

Simultaneous Exchange: In this type of exchange the property owner deeds over the relinquished property simultaneous with the receipt of the replacement property. The exchange of the relinquished property for the replacement property occurs at the same time.

Delayed Exchange: Also known as a *Starker* exchange, this type of transaction occurs when there is a time gap between the transfer of the relinquished property and the acquisition of the replacement property. This type of exchange is subjected to various time and replacement-property requirements and involves a qualified intermediary.

Improvement/Construction Exchange: This type of transaction allows the seller to construct improvements on the acquired property provided numerous technical requirements are met.

Reverse Exchange: In this type of exchange, the replacement property is acquired prior to the transfer of the relinquished property. As an example, the replacement property is acquired and "parked" with an affiliate of the qualified intermediary until a buyer is found for the relinquished property. Alternatively, the taxpayer can transfer the relinquished property to the qualified intermediary affiliate in exchange for the replacement property, with the parking entity holding the relinquished property until a buyer is located.

3. If a property owner decides on a delayed exchange, how many replacement properties can be designated?

The maximum number of replacement properties that the seller can identify is chosen from the following three options: (1) three properties of any fair market value, (2) any number of properties as long as their aggregate fair market value does not exceed 200% of the aggregate fair market value of all the relinquished properties, or (3) any number of properties provided that before the end of the exchange period the taxpayer acquires replacement properties with an aggregate fair market value equal to at least 95% of the total identified properties. If at the end of the identification period the taxpayer has identified more properties than permitted, the taxpayer is treated as if no replacement property had been identified, and thus there is a blown exchange. There are also time constraints the seller needs to be aware of – the 45-day rule and the 180-day rule. The 45-day rule requires the seller to identify the replacement properties within 45 days of transferring the relinquished property. The 180-day rule requires the seller to acquire the replacement property(ies) within 180 days of the relinquished property being transferred.

4. What is a qualified intermediary?

When property is transferred in a deferred exchange, gain or loss must be recognized if the taxpayer actually or constructively receives money or other property before actually receiving like-kind replacement property. In order to avoid this, the qualified intermediary (QI) was established. A QI is a person or entity who enters into an exchange agreement and acquires the relinquished property from the seller, transfers the relinquished property to the third-party buyer, acquires the replacement property, and transfers the replacement property to the seller. A QI cannot be the taxpayer or a "disqualified person," which includes agents of the taxpayer (i.e. attorney, accountant, investment banker or broker, or real estate agent or broker during the two-year period immediately preceding the taxpayer's transfer of the first relinquished property).

5. What is like-kind property with respect to real estate?

Fortunately for taxpayers, the type

of real estate that can be exchanged within ß1031 is extremely broad. Examples of approved like-kind properties include the following:

- Unimproved land for rental property
- City real estate for a ranch or farm
- A lease with 30 years or more to run for a fee interest in real estate
- Tenancy-in-common interest in residential rental property for condominium unit

The investment or trade or business requirements exclude personal residences from the definition of like-kind property.

6. In a tax-deferred exchange, can the seller pull some cash out of the transaction without jeopardizing the exchange?

Yes, but it will come with a tax hit. To the extent the seller pulls cash out of the deal, that piece of the transaction will be taxable as boot. If the exchanged property is depreciable, more than likely a piece of this will be taxed as depreciation recapture. To avoid receiving boot, the purchase price of the replacement property must be equal or greater than the relinquished property. You also have to go up or have an equivalent amount of debt on the replacement property. To the extent that you have a net decrease in debt in the exchange, that too is taxable as boot (as if you cashed out and paid off the debt).

7. If a property owner needs to net some cash on the transaction, is there a way of structuring it to avoid the recognition of boot?

If the replacement property can handle an increased level of debt service, the replacement property can be refinanced subsequent to the closing of the exchange to provide some liquidity to the property owner. From a planning standpoint, the taxpayer should exercise some formalities, such as using a different lender and allowing at least a few days to pass since the closing on the replacement property.

8. If a piece of property originally acquired in a tax-deferred exchange is converted to a personal residence, is the gain eligible for the $250,000 (single)/$500,000 (married filing joint) gain exclusion upon the sale of a principal residence?

A taxpayer can exclude up to $250,000 ($500,000 for certain joint returns) of gain realized on the sale or exchange of property if the property was owned and used as the taxpayer's principal residence for at least two years during the five-year period ending on the date of the sale or exchange (i.e. you must wait 5 years before the gain exclusion will apply).

Tax-deferred exchanges can be a huge benefit for those people that have underperforming real estate that has been held for a significant period of time and whose equity needs to be tapped to generate income. As with any transaction, careful tax planning and structuring is needed to achieve the desired results.

About The Author

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Chris Paris is a CPA and partner with Andersen & Company LLP in Santa Rosa. Paris provides strategic tax compliance and general business consulting to clients in the real estate development, construction contractor and professional services industries. Paris graduated with honors from UC-Santa Barbara, earning a bachelor's degree in business economics-accounting, and later received a master's of science degree in taxation *cum laude* from Golden Gate University in San Francisco. Paris is also a recipient of the "Forty under 40" award.

Since 1981, Andersen & Company has provided small to mid-sized companies, family-owned businesses, their owners and high-net-worth individuals with full-service accounting and business consulting services. The firm specializes in business valuation, litigation support, and working with clients to design and implement business succession plans.

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