ST. CROIX
IslandLife
REAL ESTATE

Introduction to 1031 Exchanges

A 1031 Exchange (Tax-Deferred Exchange) is one of the most powerful tax deferral strategies remaining available for taxpayers today. Taxpayers should never have to pay income taxes on the sale of property if they intend to reinvest the proceeds in similar or like-kind property.

The advantage of a 1031 exchange is the ability of a taxpayer to sell income, investment or business property and replace it with like-kind replacement property without having to pay federal income taxes on the transaction. A sale of property and subsequent purchase of a replacement property doesn't work. There must be an exchange**.**

Section 1031 of the Internal Revenue Code is the basis for tax-deferred exchanges. The IRS issued "safe-harbor" Regulations in 1991, which established approved procedures for exchanges under Code Section 1031. Prior to the issuance of these regulations, exchanges were subject to challenge under examination on a variety of issues. With the issuance of the 1991 regulations, tax-deferred exchanges became easier, affordable and safer than ever before.

The Disadvantages of a 1031 Exchange include a reduced basis for depreciation in the replacement property. The tax basis of replacement property is essentially the purchase price of the replacement property minus the gain, which was deferred on the sale of the relinquished property as a result of the exchange. The replacement property thus includes a deferred gain that will be taxed in the future if the taxpayer cashes out of his/her investment.

Exchange Techniques

There is more than one way to structure a tax-deferred exchange under Section 1031 of the Internal Revenue Code. However, the 1991 "safe-harbor" regulations established procedures which include the use of an Intermediary, direct deeding, the use of qualified escrow accounts for temporary holding of "exchange funds," and other procedures which now have the official blessing of the IRS. Therefore, it is desirable to structure exchanges so that they can be in harmony with the 1991 Regulations. As a result, exchanges commonly employ the services of an Intermediary with direct deeding.

Exchanges can also occur without the services of an Intermediary when parties to an exchange are willing to exchange deeds or if they are willing to enter into an Exchange Agreement with each other. However, two-party exchanges are rare since, in the typical Section 1031 transaction, the seller of the replacement property is not the buyer of the taxpayer's relinquished property.

The Basic Rules for a 1031 Exchange

1. The relinquished 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/her office facilities or place of doing business, as well as equipment used in his/her trade or business. Real estate must be replaced with like-kind real estate. Equipment must be replaced with like-kind equipment.

2. Property which does not qualify for a 1031 Exchange includes:
    - A personal residence
    - Land under development for resale
    - Construction or fix/flips for resale
    - Property purchased or held for resale
    - Inventory property
    - Corporation common stock
    - Bonds
    - Notes
    - Partnership interests

3. Replacement property title must be taken in the same names as the relinquished property was titled. If a husband and wife own property in joint tenancy or as tenants in common, the replacement property must be deeded to both spouses, either as joint tenants or as tenants in common. Corporations, partnerships, limited liability companies and trusts must be in title on the replacement property the same as they were on the relinquished property.

4. 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.

5. 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 relinquished 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.

The Basic Types of Exchanges

A Simultaneous Exchange is an exchange in which the closing of the relinquished 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 relinquished 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 relinquished property is sold. Usually the Intermediary takes title to the replacement property and holds title until the taxpayer can find a buyer for his relinquished property and close on the sale under an Exchange Agreement with the Intermediary. Subsequent to the closing of the relinquished 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 (see below).

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.

Delayed Exchanges – The Exchange Process and Time Clocks

A taxpayer desiring to do a 1031 Exchange lists and/or markets his/her 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 time 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 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 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.

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.

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/her relinquished property. Sometimes the exchange accommodation titleholder will take and hold title to the relinquished property until a buyer is found for it. Reverse Exchanges have been common and have been preferred in circumstances where 1) a taxpayer has been compelled to close on replacement property before a relinquished property could be sold and closed or where 2) the taxpayer desired ample time to search for suitable replacement property before selling a relinquished property (which had 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 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" 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. 180 days may be a suitable time for a buyer to be found for the relinquished 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 Relinquished 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/her 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 to have a higher degree of audit risk, now that guidelines have been issued for safe-harbor exchanges.

The Role of the Qualified Intermediary

The role of a 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.

Partnership and Co-Ownership Issues

Investment real estate is commonly owned by co-owners in a partnership containing two or more partners, or by co-owners as tenants in common. An exchange of a tenant-in-common interest in real estate poses no problems and is eligible for 1031 Exchange treatment. However, an exchange of an interest in a partnership is not permitted under the Code and Regulations.

If a partnership owns property and desires to sale/exchange the property, then the partnership is the entity that is the Exchanger and party to the Exchange Agreement. The partnership will take title to the replacement property.

Frequently, individual partners in a partnership desire to take their share of the proceeds of sale of the partnership property, replace with qualifying 1031 replacement property in their own names and end their relationship with the partnership. This presents problems that require careful planning and is not without tax risk.

If a two-partner partnership wishes to discontinue the partnership, sell the property and go their separate ways with either the cash or a 1031 Exchange, it is necessary for the individual partners to receive deed to the property from the partnership in advance of the sale of the property. This is done in the context of a distribution of property from the partnership to its partners. The individual partners are then generally required to hold the property as tenants in common for an unspecified period of time (decent interval of time) in order to comply with the "held-for" requirement of 1031 Exchanges that requires a taxpayer to have "held" qualifying property for business or investment purposes prior to the exchange.

If a partnership with multiple partners wishes to exchange property but some of the partners want to "cash-out" or go separate ways, it is common for the partnership to do a "split-off." The partnership distributes tenancy in common title to a portion of the partnership property to those individual partners who wish to proceed in separate directions, and the partnership (and its remaining partners) proceed with an exchange in the name of the partnership.

The services of a tax professional are essential for tax planning and structuring for successful exchanges of partnership and co-ownership interests in real estate.

Accommodation Language in the Contract.

Accommodation language is usually placed in Contracts to Buy and Sell Real Estate wherein the other party to the contract is informed and agrees to cooperate with the 1031 exchange. Typical accommodation language might read as follows:

> **For a Seller -** "A material part of the consideration to the seller for selling is that the seller has the option to qualify this transaction as a tax-deferred exchange under Section 1031 of the Internal Revenue Code. Purchaser agrees to cooperate in the exchange provided purchaser incurs no additional liability, cost or expense."
>
> **For a Buyer -** "This offer is conditional upon the seller's cooperation at no cost to allow the purchaser to participate in an exchange under Section 1031 of the Internal Revenue Code at no additional cost or expense. Seller hereby grants buyer permission to assign this Contract to an Intermediary not withstanding any other language to the contrary in this Contract".

Accommodation language is not mandatory and can be omitted if it puts the taxpayer to a disadvantage for other parties to know about his plan to sell and replace property.

Assignment of Contracts

If a Realtor knows that a buyer intends to assign the contract to an Intermediary in connection with an exchange, it is helpful to reference the buyer as "John Doe or Assigns" on the contract.

Kim Lucas, REALTOR®
340-626-3758 (cell)
kim@email.vi
St Croix Island Life Real Estate
5100 Chenay Bay
Christiansted, Virgin Islands 00820