

Tax Deferred Exchanges Under IRC Section 1031 By William P. Walzer

Many of our clients have inquired about their ability to defer income tax on the sale of real property by exchanging it with real property they wish to acquire. These questions are particularly apt, for example, when a retiring business owner wants to sell his business together with its owned business location, and use the proceeds to purchase investment property having a lesser management burden.

The advantage to a properly structured exchange transaction is that gain on the sale is not recognized in the year of the disposition. But the gain generally won't escape taxation altogether. The acquired property will have a basis reduced by the gain which escaped taxation upon the sale. The tax which was deferred will be due when the taxpayer sells the acquired property, and will escape taxation only if the taxpayer dies owning the acquired property. The acquired property will also have a reduced basis for depreciation purposes.

Space does not permit us to list all the rules applicable to like kind exchanges, but some general observations may be helpful.

Both the "relinquished" (sold) property and the "replacement" (purchased) property must be property held for investment purposes or for productive use in the taxpayer's trade or business. As long as both properties qualify, taxpayers are free to purchase whatever type of property they want. For example, property in which the taxpayer has operated a business can be exchanged for property which the taxpayer will simply rent to others. A factory can be exchanged for a multi-family building.

There are other restrictions as well: Real property which is sold in the ordinary course of the taxpayer's business is not qualified property, so new construction developers ordinarily can't take advantage of an exchange. Neither can a taxpayer who acquires a home to fix up and flip. Property held for resale in a real estate company's inventory isn't held for investment. A taxpayer's residence is not qualified property and a taxpayer can't exchange investment property for residential property in which he intends (initially) to reside. United States property and foreign property are not like kind.

There can be no substitution of taxpayers in a qualified exchange. The entity that holds title to the relinquished property must acquire the replacement property. Principals of an entity who wish to disband their relationship may, under certain circumstances, transfer the property to be relinquished to the principals individually before the exchange transaction is implemented.

The relative values and financing of the relinquished and replacement properties will determine whether the taxpayer achieves a complete deferral of income tax. For example, a taxpayer who seeks to buy a replacement property of a lesser

value, or with less financing, will have to recognize income on the amount not reinvested in the replacement property.

The logistics and types of exchanges are important. Rarely can a direct, simultaneous exchange be arranged with two parties. Most commonly, our clients effect delayed or reverse exchanges through an independent exchange intermediary. In a delayed exchange, the taxpayer concludes the sale of the relinquished property prior to acquiring the replacement property, with the proceeds deposited with the intermediary until they are utilized to acquire the replacement property. The replacement property must be identified in writing within 45 days of the sale, and acquired within 180 days of the sale. More than one replacement property may be identified and acquired, subject to limitations on number and value.

Reverse exchanges are useful in circumstances where a taxpayer will be compelled to close on replacement property before the property to be relinquished can be sold. The property to be relinquished may be deeded to an Exchange Accommodation Titleholder (EAT) to take and hold title until the taxpayer finds a buyer for his relinquished property. IRS's safe harbor guidance indicates that the relinquished property should be identified within 45 days of the acquisition of the replacement property sold within 180 days. In a variation of this structure the EAT will take and hold title to the replacement property until a buyer can be found for the relinquished property.

Clients sometimes wish to construct improvements on the replacement property. This may be necessary to equalize the values of the properties being exchanged. But the cost of improvements expended after the exchange is included won't be regarded as part of the exchange consideration. The problem may be overcome utilizing a reverse exchange and performing construction while the replacement property is owned by an EAT.

Section 1031 of the IRC and its associated rules are complex. Missteps will result in unexpected tax liability. The tax and real estate professionals at Roy P. Kozupsky & Associates, LLP have the experience and understanding of exchange issues to guide our clients through the exchange morass.