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SECTION 1031 TAX DEFERRED EXCHANGES: AN OVERVIEW

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Tenants in Common & Section 1031 Tax-Deferred Exchanges: An Overview

Internal Revenue Code Section 1031 provides that no gain or loss will be recognized on the exchange of property held for investment or used in a trade or business, if the property is exchanged solely for "like-kind" property that will also be held for investment or business use. In other words, if a taxpayer were to use one of the established methods, he or she could sell their real estate or business assets that have been held for investment or used in a trade, defer taxes on that sale and use all of the sales proceeds to purchase other property of the same nature or character (otherwise known as "like-kind" property).

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Why would someone wish to participate in a Section 1031 exchange?

By allowing the taxpayer who is conducting the exchange (the "Exchanger") to defer the taxes on any gains from the sale of his previously held property (the "Relinquished Property"), the taxpayer, in essence, receives an interest-free loan from the federal government in the form of the additional available cash that would have gone to taxes that can now be used to "step up" his investments. Therefore, an exchange can be valuable to an individual or business for a variety of reasons, including:

- Exchanging from depreciated property to higher value property that can be depreciated
- Exchange from property that cannot be refinanced, such as land, to improved property that will support a new loan
- Exchanging from unproductive land to improved land capable of producing cash flow
- Exchanging productive land, to higher cash flow property to generate greater current income
- Exchange to property with faster or greater appreciation
- Exchange for relocation of business operations
- Exchange to diversify or consolidate holdings
- Exchange depreciated equipment or vehicles for similar new equipment or vehicles

What kinds of property can take advantage of Section 1031?

Essentially, Section 1031 can be used to conduct exchanges relating to real estate and tangible personal property. A leasehold interest in real estate for 30 years or more qualifies for Section 1031 tax treatment. Undivided tenant-in-common interests in real estate also qualify. Depending on whether state law treats such rights as an interest in real property, timber, mineral and water rights can qualify for Section 1031 tax treatment.

Section 1031 does **not** apply to:

- Inventory or property held primarily for sale
- Stocks, bonds or notes
- Securities or evidences of indebtedness or interest
- Certificates of trust or beneficial interest
- Interests in partnerships
- Choses in action

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Whether personal or real property is being held for sale rather than for a trade or business, or for investment, is largely a "facts and circumstances" determination in which the Exchanger's intent is considered, along with other factors such as how long the property is held, whether advertisement is used, the Exchanger's business and nature and extent of efforts by owner to sell property. While the IRS has provided little guidance on the subject, there is precedent for the general rule of thumb that property held for at least two years, is held for investment or for a trade or business, rather than for sale.

What is "like-kind" property?

The nature and character of property determines whether it is like-kind or not, not its quality or use. Generally, all real property is "like kind" to other real property. Thus:

1) Residential Rental Home --> exchanged for --> Residential Rental Home
2) Unimproved Land --> exchanged for --> Tenant-in-Common Interest in a Shopping Center
3) Apartment Complex --> exchanged for --> Industrial Warehouse
4) 30 Year Leasehold Interest --> exchanged for --> Office Complex

Personal property cannot be exchanged for real property since the personal property is different in nature and character to the Replacement Property, i.e.: land.

What are the types of Section 1031 exchanges?

The most basic type of Section 1031 exchange is the "simultaneous exchange," which is simply a direct "swap" of investment or business property. This form of exchange is rare due to the simple fact that finding two property owners that wish to conduct a direct swap is difficult.

The most common form of Section 1031 exchange is called a "deferred exchange." Under a deferred exchange, the Exchanger will sell the Relinquished Property and then subsequently purchase the Replacement Property. In so doing, the Exchanger will engage an independent third-party known as a "Qualified Intermediary," whose role will be to hold the proceeds of sale on the Relinquished Property in escrow and then transfer the funds to the Seller of the Replacement Property upon closing. While the Exchanger will assign the contracts of sale and purchase on the properties to the Qualified Intermediary, title to the properties will be conveyed and received by the Exchanger through direct deed. By utilizing the Qualified Intermediary, the Exchanger never controls the monies sought to be used in the exchange, thus never "realizing" the gain from the sale, and the separate sale and purchase can be treated as connected aspects of the same Section 1031 exchange. Any money or unqualified property which the Exchanger is deemed to have actually or constructively received (i.e. is paid over to the Exchanger rather than the Qualified Intermediary) will not be eligible for tax deferral under Section 1031.

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Another form of Section 1031 exchange is called a "reverse exchange." In a reverse exchange, the Exchanger purchases his Replacement Property and then subsequently sells his Relinquished Property. Under this scenario, a party known as an Exchange Accommodation Titleholder ("EAT") must actually hold title to the properties during the exchange, rather than permitting the Exchanger to convey and receive title to his properties through the direct deeding allowed under a deferred exchange. Furthermore, the EAT will be treated as the beneficial owner of the properties for all federal income tax purposes. To ensure proper calculation of the tax obligations, the Exchanger and the EAT must have a detailed agreement (known as a "Qualified Exchange Accommodation Arrangement") which describes the relationship between the parties, and which agreement will include reporting requirements for the Exchanger and EAT on the acquisition, holding and disposition of the properties on their respective federal income tax returns. Thus, the added complexities of a reverse exchange may make them less desirable to the Exchanger, if other exchange options are possible.

How is a "deferred exchange" conducted?

The first step is that the Exchanger will enter into a sales contract to sell his Relinquished Property. The contract need not use special language, but should include a simple statement that the seller will be involved in a Section 1031 exchange and that the buyer agrees to cooperate. This language is included to put the buyer on notice of the exchange, and to demonstrate to the IRS that the Exchanger had the requisite intent to conduct a like-kind exchange. Sales contracts that do not notify the buyer of the pending 1031 are not defective, but should include a subsequent addendum to include such notice. Once the contract has been executed, the Exchanger will send a copy of the sales contract to his Qualified Intermediary.

Next, the Exchanger will enter into an Exchange Agreement with the Qualified Intermediary. This Exchange Agreement will be provided by the Qualified Intermediary and will detail the relationship between the parties and the means by which the exchange will take place. The Exchanger will also execute an "Assignment Agreement," also provided by the Qualified Intermediary, whereby the Exchanger will assign his interest in the contract for sale of the Relinquished Property to the Qualified Intermediary. As part of the documentation, the Qualified Intermediary will provide the Exchanger with a notice of the assignment that will be sent to the purchaser of the Relinquished Property notifying the purchaser of the exchange. At closing, the proceeds of sale will be wired directly to the Qualified Intermediary, and the Exchanger will have no right to access the funds. At our firm, we typically try to place these funds in interest earning accounts so that the Exchanger's money is productive during the holding period.

Once all the documentation has been executed, the next step in the exchange process will be for the Exchanger to close on the sale of his Relinquished Property. A properly drafted Exchange Agreement will permit directed deeding of title to the Relinquished Property from the Exchanger to the buyer of that property, without the need to transfer title to the Qualified Intermediary.

From the date of the transfer of the Relinquished Property, Section 1031 of the Code requires that the Exchanger "identify" his Replacement Property by the end of the forty-fifth (45) day. The IRS does not grant extensions of this 45-day rule. The Exchanger "identifies" the Replacement Property by sending a letter (the form of which is often provided by the Qualified Intermediary) which lists up to three (3) properties the Exchanger is interested in purchasing as the Replacement Property. The Exchanger must purchase at least one of the identified properties.

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Additionally, Section 1031 requires that the Exchanger must close upon at least one of the identified properties within the earlier of one hundred eight (180) days of the transfer of the Relinquished Property (or 135 days past the last day allowed to "identify" the Replacement Property), or on or before the due date (including extensions) for the taxpayer's tax return for the taxable year in which the transfer of the Relinquished Property occurs. Any failure to comply with the time limits set forth by the IRS will result in a disqualification of Section 1031's tax deferment.

Following the Exchanger's identification of his Replacement Property, the Exchanger will enter into a purchase agreement with the seller. As had been done with the Relinquished Property, the purchase contract should notify the seller that the purchaser will be conducting a Section 1031 like-kind exchange. Again, the Exchanger will send the Qualified Intermediary a copy of the purchase contract, will execute an Assignment Agreement, which will assign the purchase contract to the Qualified Intermediary, and send the seller a letter agreement committing the seller to cooperate with the Exchanger in facilitating the exchange.

At the closing on the Replacement Property, the Qualified Intermediary will wire the proceeds of sale from the Relinquished Property to the seller. The seller will be instructed to direct deed the title to the Replacement Property to the Exchanger. With this final step the Section 1031 exchange is complete. Once the transaction is complete, our firm sends the Exchanger a binder containing each of the executed documents following the conclusion of the exchange so as to have a complete and accurate record available to provide to the IRS, if necessary.

Are there debt and equity requirements in a Section 1031 exchange?

Any monies from the net proceeds of sale on the Relinquished Property that are not reinvested in like-kind property will be taxed as gains. These amounts are referred to as "Boot." While the Internal Revenue Code does not require specific dollar amounts to engage in a Section 1031 exchange, it does require that the Exchanger acquire Replacement Property that has as much debt and equity as the Exchanger had in his Relinquished Property to avoid "Boot." For example, if an Exchanger sold his Relinquished Property for two hundred thousand dollars ($200,000), paid off a one hundred thousand dollar ($100,000) mortgage and made a one hundred thousand dollar ($100,000) profit, in order to qualify for complete tax deferral, the Exchanger would need to have at least $100,000 in equity and $100,000 in debt in the Replacement Property. Alternatively, the Exchanger could replace the debt requirement by matching its level with a cash investment.

Any money or unqualified property which the Exchanger is deemed to have actually or constructively received (i.e. is paid over to the Exchanger rather than the Qualified Intermediary at closing) will not be eligible for deferred tax treatment under Section 1031.

Qualified Intermediary Services Provided By Gregory, Hoctor & Kaplan, PLC

Gregory, Hoctor & Kaplan, PLC is a boutique business law firm headquartered in Richmond, Virginia, which provides Qualified Intermediary services related to Internal Revenue Code Section 1031 "like-kind" exchanges. Gregory, Hoctor & Kaplan's services are charged as a flat-fee based upon the value of the exchange and the number of replacement properties purchased. Fees typically range from $750-2500 per exchange, and $200 for each additional replacement property after the first selected.

In addition to the cost-effectiveness of our services, we consider our Qualified Intermediary services as any other aspect of our practice and try to provide meaningful guidance to the Exchanger throughout the process. That includes providing extra "value-adds." For example, we will assist clients in locating suitable investment property, should they require it, for no extra charge. We can also introduce our 1031 exchange clients to the commercial real estate syndication industry, which is especially tailored to 1031 exchangers, thereby allowing them to take advantage of the increased cash flows associated with significant commercial real estate.

Contact Information

For questions about our Section 1031 services, call Chris Hoctor at (804) 897-0648, or Rob Kaplan at (804) 897-0645. We look forward to servicing all of your Section 1031 needs.

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