Accruit Exchange

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Accruit

Accruit's clients have significantly increased their cash flow utilizing 1031 Like-Kind Exchanges for both Real Estate and personal property. We hope you enjoy Part III, which concludes our series on Understanding Tax Deferred Exchanges of Real Estate.

Understanding a 1031 Tax Deferred Exchange of Real Estate: Part III

By Martin S. Edwards, Vice President & General Counsel, Accruit and President North Star Deferred Exchange LLC

Avoiding Actual or Constructive Receipt

Actual or constructive receipt of funds by the taxpayer while the exchange is pending is fatal to a valid exchange. According to the 1991 regulations, the taxpayer is in actual receipt of the funds any time that the taxpayer receives the economic benefit of the money. The current regulations also state that the taxpayer is in constructive receipt when the funds are "credited to the taxpayer's account, set apart for the taxpayer, or otherwise made available so that the taxpayer may draw upon it…."The regulations suggest three basic ways to structure an exchange to avoid a possible determination of actual or constructive receipt. The term "safe harbor" is used in the regulations to describe these structures. The first safe harbor permits the purchaser's obligation to provide replacement property to be secured by a mortgage, letter of credit, or third-party guarantee. The second safe harbor secures the purchaser's obligation to furnish replacement property by placement of the funds in a qualified escrow or trust account. The practical problem with the first two safe harbors is that each requires the purchaser ("the taxpayer's transferee") to be an ongoing participant in the exchange to a greater extent than simply acquiring the relinquished property. Under these safe harbors, the purchaser must enter into a contract to purchase the replacement property, possibly subjecting himself to unwanted contractual obligations and liabilities. Most relinquished property buyers readily agree to nominally participate in an exchange but are unwilling to become involved to the extent required by the first two safe harbors. At times, some buyers may be willing to participate but wish to receive compensation for themselves and their attorneys.

Upcoming Events

February

- 18-23: Ritchie Bros. Orlando Auction

March

- 3-6: Truckload Carriers' Association Conference
- 12-14: FEA Washington Fly-In

April

- 15-16: Auto Rental News Car Rental Conference

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The Qualified Intermediary

The third safe harbor involves the use of a qualified intermediary. The intermediary, usually in conjunction with a qualified escrow or trust, not only safeguards the funds during the exchange period but also facilitates the exchange, making the relinquished property purchaser's involvement unnecessary. To perfect the exchange under this safe harbor, the qualified intermediary must either acquire title to the relinquished and replacement property, or must enter into a contract with the relinquished property buyer and replacement property seller for the transfer of each property. In lieu of actual execution of the contract, the necessary contract rights may vest in the intermediary as a result of an assignment of contract rights from the taxpayer to the intermediary. If the assignment of contract rights option is used, as is most often the case, written notice of the assignment must be given from the taxpayer to all parties to the contract. For example, this means that one of two co-owners who are contemplating an exchange of his or her share must notify both the buyer and the co-owner/seller. The qualified intermediary safe harbor has several interesting aspects. This relationship departs from general exchange rules regarding agency, and expressly allows the intermediary to enter into the contracts as an agent of the taxpayer. Also, use of the qualified intermediary is the only method specifically recognized under the regulations for structuring a simultaneous exchange. Regardless of which safe harbor is used, once the taxpayer has any right to receive, pledge, borrow, or obtain the benefits of the funds, the safe harbor ceases to apply. Valid exchanges can be accomplished without use of a safe harbor, but they will run the risk of closer scrutiny by the IRS. The regulations also permit the payment to the taxpayer of interest or a "growth factor" without imputing constructive receipt. This interest is not part of the deferred exchange funds, and is taxable to the taxpayer in the same manner as any other type of interest earned. This can create an interesting problem for taxpayers whose transaction crosses into a second tax year. They cannot receive the interest until the exchange transaction is completed; yet they will receive a 1099 for the prior year in which some interest was earned in the account.

Non-qualified Escrowees, Trustees, and Intermediaries

The last portion of the regulations deals with the definition of persons or entities disqualified from acting as qualified escrowee, trustee, or intermediary. Essentially, anyone who has acted as the taxpayer's employee, attorney, accountant, investment banker, broker, or real estate agent within two years prior to the transfer of the relinquished property is disqualified. There is an exception to this disqualification rule for providers of routine financial, title insurance, escrow, or trust services. Entities from this group can act to facilitate an exchange without risk of being disqualified.

The Benefits of Tax Deferred Exchanges

In addition to the obvious benefit of being able to defer payment of tax, there are other benefits to exchanges. One example is owners who wish to liquidate management-intensive property for "triple net lease" property without a diminution in cash flow can benefit from an exchange. This may be particularly important for an older, married co-owner who experiences the death of a spouse. Should the surviving spouse be unable to keep up the property management, he or she might consider a sale of the property. In many instances, this would result in the payment of a substantial capital gain and would reduce the amount of cash to reinvest. In addition, in these situations if the surviving spouse is counseled to consider an exchange, not only is the gain deferred but also upon his or her death, the estate takes a stepped up basis. As a result, the value of the survivor's estate is increased by the amount that would have otherwise been paid as the capital gain. Upon the death of the survivor, the heirs take the property with a stepped up basis and the deferred gains never need to be paid. Other scenarios for which tax-deferred exchanges should be considered include when property owners move out of town and are no longer able to manage their real estate investments but do not wish to sell the property and pay a potentially large gain. Also, many companies who own real estate, frequently and routinely upgrade equipment, machinery, vehicles, or assets out on lease may find real benefits to treating those upgrades as trades rather than sales and purchases. Regulations passed in 1994 provide that if that if a taxpayer sells his primary property in one tax year as part of a bona fide exchange, and the exchange fails, resulting in return to the taxpayer of the escrowed funds in another tax year, the gain is reportable in the year in which the funds are received, and not in the year the sale took place. In these instances, the taxpayer receives interest on the deposit and delays payment of the capital gains tax for a year.

For more information on real estate exchanges, please contact Martin Edwards or Tracey Wilson at (312) 207-1031