UNDERSTANDING TAX-DEFERRED EXCHANGES OF REAL ESTATE

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The concept of tax-deferred exchanges is quite simple: If one trades property for like-kind property and does not receive any cash or other non-like-kind property, then no profit has been made, and there are no immediate tax consequences. While the basis in the replacement property is affected, any gain is deferred until the eventual sale of the replacement property.

Tax-deferred exchanges of real estate and personal property have been recognized by the I.R.C. since the 1920s, and regulations introduced in 1991 made structuring such transactions easier. Despite the ease in structuring these deals, the public's level of awareness of the tax benefits of exchanging property has been slow to develop. In addition, many legal advisers have not familiarized themselves with the detailed regulations and benefits of tax-deferred exchanges.

A number of factors recently converged to make tax-deferred exchanges an attractive alternative to outright property sales. The first of these factors was the loss of the favorable capital gains tax maximum rate of 20 percent, which was eliminated by the Tax Reduction Act of 1986. Taxpayers now have a strong motivation to seek a deferral of taxes by exchanging property for replacement property, thus avoiding taxation based upon the rate for the taxpayer's ordinary income tax bracket.

I was not, however, until the landmark decision in the case of *Starker v. U.S.* (602 F.2d 1341 (9th Cir. 199)) that an exchange became practical for everyday transactions. As a result of the *Starker* decision, it became possible to accomplish a valid exchange on a nonsimultaneous basis. Prior to that time, to accomplish an exchange, a taxpayer had to locate a replacement property in advance and prepare to close the sale of the primary property and the replacement property as part of a single complicated escrow.

Understanding the Rules

I.R.C. § 1031 applies only to like-kind exchanges of property "held for productive use in trade or business or for investment." Owner-occupied residential property and property held as inventory for sale do not qualify. Also excluded are stocks, bonds, securities, partnership interests, and certificates of trust or beneficial interest. In the case of real estate exchanges, the like-kind standard is usually easy to satisfy. Generally, any type of real property interest is like-kind to any other type of real property. The properties do not have to be of the same nature.

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For example, a single-family home held as rental property could be exchanged for a vacant parcel of land purchased as an investment. Similarly, a leasehold interest of 30 or more years could be exchanged for a strip shopping center, and the sale of a fee interest in real estate can be exchanged for a purchaser's interest under an installment agreement for deed. Even the transfer of a fee interest in real estate is like-kind to certain non-fee interests in real estate such as long-term leases and purchases under an installment agreement.

In some respects, the determination of like-kind in the area of personal property is more difficult. In most cases, in order for two items of personal property to be like-kind, those items must share the same General Business Asset Class (see Rev. Proc. 87-56, 1987-2 C.B. 674, as modified), or share the same Product Class by reference to a product code listed for all depreciable personal property assets in the

Standard Industrial Classification Manual (1987). (Please note: As of January 1, 1997, the standard industrial classification system will no longer be in effect. Taking its place will be a new system, currently being devised, which will be known as the North American Classification System.)

After the taxpayer's relinquished property is transferred to the purchaser (referred to as "the taxpayer's transferee"), the taxpayer must identify and receive replacement property within a certain timeframe. The identification must take place within 45 calendar days of the transfer of the relinquished property. The end date cannot be extended even if it falls on a holiday or a weekend.

The replacement property must be transferred to the taxpayer within 180 days of the closing of the relinquished property or by the due date for filing (including extensions) of the taxpayer's tax return. This time period cannot be extended even if it falls on a non-business day. If multiple properties are transferred on different dates as part of a single exchange, then the applicable time periods begin on the earliest date on which any of the property is transferred.

Identification of replacement property takes place in a written document that is signed by the taxpayer and is delivered in person, by mail, or by facsimile transmission to anyone else involved in the exchange. Parties should avoid having the identification signed by a single spouse on behalf of both spouses or by an agent pursuant to a power of attorney. Replacement real property must be described specifically by using a legal description, street address, or distinguishable name. According to the new regulations, for property to be constructed, identification must be in as much detail as possible. Conservative practitioners may wish to attach plans and specifications to play it safe. (See "Treatment of Property to Be Constructed," page 27.)

Personal property should be specifically described by the particular type of property: the regulations give an example of a truck identified by a specific make, model, and year. Businesses acting as qualified intermediaries encourage that identification be made to them, but as a technical matter, the identification can duly be made to the relinquished property buyer, the replacement property seller, or the closing escrowee.

The current regulations allow identification of up to three alternative properties without regard to market value. A taxpayer can choose to close on any one or more of them without reference to priorities.

If, however, a taxpayer should identify more than three properties, he must close on all the properties identified unless he falls under the so-called "200 percent rule." This rule provides that an unlimited number of properties may be identified so long as the aggregate fair market value of them does not exceed 200 percent of the fair market value of the relinquished property. If a taxpayer falls within this rule, then there is no failure of the exchange, even if the taxpayer does not close on all the properties identified.

On final identification-related rule is the "95 percent rule." Under this provision, even if the taxpayer exceeds the three-property rule and does not fall within the 200 percent rule, the exchange is valid to the extent that the taxpayer receives at least 95 percent of the fair market value of all the property identified. In practice, almost all taxpayers operate within the three-property rule rather than subjecting themselves to the two other, more restrictive rules.

Incidental personal property that is customarily transferred as part of a particular type of commercial transaction does not need to be separately identified as long as the value of the personal property is not greater than 15 percent of the fair market value of the real property. An example of this would be the purchase of appliances as part of the purchase of an apartment building. Note that the incidental property rules excuses identification of the personal property only; an analysis must still be made to determine that the actual replacement personal property is like-kind to

Treatment of Property to Be Constructed

When identifying property to be constructed, great care must be taken to acquire constructed property and not construction services. If constructed property is not completed by the time of transfer to the taxpayer, only the value as of the date of transfer may be used to offset gain. Any construction completed after the date of transfer constitutes the purchase of construction services and is not considered part of the exchange.

If possible, taxpayers should arrange to have the builder retain ownership of the property at least until the value of the property is equal or greater than the amount held in the exchange account (but in no case beyond the 180-day exchange period). Similarly, in the case of a sale of improved property, additional improvements desired by the taxpayer should be placed on the property by the seller prior to acquisition of the replacement property, if possible. The purchase price will typically be increased by the cost of those additional improvements, which will enable the taxpayer to defer tax on those additional amounts.

For example, the taxpayer expects to have $20,000 left in the exchange account upon conclusion of the purchase of replacement property. The taxpayer knows he will have certain improvements to make including installation of a new roof. Applying the $20,000 in a timely fashion toward the cost of the new roof will not help the taxpayer defer that additional amount. But should the taxpayer be able to induce the seller to put on the new roof and simply add the cost to the purchase price, the taxpayer could defer that additional sum.

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. For example, when the replacement property is ultimately sold, a new, lower capital gains tax rate may once again be in effect. If a taxpayer sold property today, he could be taxed at a 31 percent tax rate. However, if a lower capital gains rate or a flat tax rate is in effect at the time the replacement property is sold, the tax on the original gain could be the lower capital gains rate or the flat tax rate (which could be 20 percent or lower). The taxpayer would benefit not only from tax deferral but also by making the payment at that lower rate.

In addition, 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 the estate passed on upon the death of the surviving spouse. However, if in these situations 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.

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, companies that frequently and routinely upgrade equipment, machinery, vehicles, and 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 receipt by 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.

the personal property transferred as part of the disposition of the relinquished real property. There is a tendency to disregard the value of the personal property as part of a real estate purchase when trading up. This could be a mistake if the replacement personal property is not of like-kind and/or is of equal or greater value. The ability to place personal property into exchange groups and residual groups can facilitate the accounting pertaining to personal property assets.

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 involved 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.

The qualified intermediary safe harbor. 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 minimal. 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, 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 is contemplating an exchange of his or her share must notify both the buyer and the co-owner.

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 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 be subject to very close 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.

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