

The 1031 Exchange in Forward or Reverse: Critical Components and Common Pitfalls

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A 1031 Exchange is the short-hand nickname used to refer to a tax-deferred, like-kind exchange pursuant to Section 1031 of the Internal Revenue Code and Section 1.1031 of the Department of the Treasury Regulations. A typical forward 1031 Exchange allows you to sell investment property (the “relinquished property”) and purchase more productive or profitable investment property (the “like-kind replacement property”) while deferring federal (and in Idaho and most other states) capital gain and depreciation recapture tax liabilities. There are times, however, where it may be advantageous to engage in a Reverse 1031 Exchange: acquire the replacement property first and then sell the relinquished property. Both types of 1031 Exchanges will be discussed in greater detail below.

The 1031 exchange

The following is a short synopsis of the basic rules and requirements of a 1031 Exchange.

Qualified intermediary

The first step in a 1031 Exchange is to identify a qualified intermediary, also called a 1031 accommodator or facilitator. The qualified intermediary provides the 1031 Exchange agreements to properly structure the 1031 Exchange transaction, which incorporates both the first sale and the subsequent purchase, all wrapped up into one transaction. The purchase and sale agreement is assigned to the qualified intermediary, and the escrow instructions and any other transactional documents

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must also incorporate the qualified intermediary. This is true for both the sale of the relinquished property and the purchase of each like-kind replacement property. The qualified intermediary holds the 1031 Exchange funds during the process — and in fact, this is a vital requirement, as the taxpayer is not allowed to have any actual or constructive receipt of the funds. If the taxpayer receives the funds, he or she will not qualify for recognition under Section 1031.

Qualified use property

The relinquished property must be held for rental, investment or use in a business. The requisite intent must be to hold the like-kind replacement property for rental, investment or use in business. Non-qualifying property on either the relinquished or replacement side will cause the entire exchange to not qualify for the tax deferral. For example, buying a fixer-upper with the intent to repair and remodel the property and then sell it — essentially flipping the property — is considered by the IRS to be property held for sale (like inventory) and not for investment. Flipping properties will not qualify for any tax deferral and will instead be taxed as ordinary income.

Like-kind property

The relinquished property and the replacement property must be like-kind to qualify for tax-deferred treatment. “Like-kind” does not mean an apartment complex for an apartment complex; rather, it refers to real property held for investment. An apartment complex may be exchanged for industrial property, for example, or vacant land held for investment may be exchanged for a single family residence used as a rental property. Per Section 1.1031 of the Department of Treasury Regulations, non-like-kind property includes things like stock, bonds, notes, or securities.

Same tax-paying entity

The like-kind replacement property must be acquired by the same tax-paying entity that sold the relinquished property. The IRS, however, has recognized that a taxpayer may form a single-member limited liability company to acquire the replacement property so long as the sole member of the LLC is the taxpayer.

Less than 100% ownership

Multiple properties may be exchanged for one property, or one property may be exchanged for a

fractional interest in the replacement property. In other words, 100% of the property does not have to be sold or acquired on either end of the 1031 Exchange, as long as the value requirements are met (see *Tax Ramifications*, below).

Identification requirements

To qualify for a 1031 Exchange, one of the following three rules must be met:

1. **The Three Property Rule.** The most common rule allows a taxpayer to identify up to three potential like-kind properties so that there is flexibility in the replacement property — in case the taxpayer's first choice falls through. There is no market value limitation under this rule, which is the easiest framework to work within.
2. **The 200% of Fair Market Value Rule.** This rule allows a taxpayer to identify as many properties as he or she likes, so long as the aggregate value does not exceed 200% of the sales price of the relinquished property.
3. **The 95% Exception Rule.** If the identified properties exceed the three property rule and the 200% rule, the identification will still be considered valid for 1031 Exchange treatment if the acquisition is at least 95% of the fair market value of the replacement properties that were identified.

Time restrictions

A 1031 Exchange involves very strict time restrictions that cannot be extended or waived. The like-kind replacement properties must be identified within 45 calendar days from the date of sale of the relinquished property. Properties may be revoked and re-identified as many times as necessary during that 45 day period. The acquisition of the like-kind property or properties must be completed on the earlier of (1) 180 calendar days from the close of the

relinquished property or (2) the due date (including extensions) of the federal income tax return for the year in which the relinquished property was sold.

Reverse 1031 exchange

In a Reverse 1031 Exchange, the replacement property is purchased before the relinquished property is sold. The replacement property is acquired in the name of the "exchange accommodation titleholder" on the taxpayer's behalf. An exchange accommodation titleholder is a single-member limited liability company formed by a qualified intermediary for use in a single specific reverse exchange.

Certain requirements must be met in order to defer 100% of the capital gain and depreciation recapture tax liabilities that would otherwise be an obligation upon a sale of investment property.

Safe harbor in a reverse 1031 exchange

The IRS has published requirements that provide for a "safe harbor" in a Reverse 1031 Exchange. A safe harbor is satisfied if there is an "accommodation arrangement" where the following requirements are met:

1. Title to both the replacement property and the relinquished property are held by a qualified accommodator.

2. The taxpayer has a bona fide intent that the property held by the qualified accommodator is property that is intended to qualify for tax deferment.

3. No later than five days after the qualified accommodator takes title to the replacement property, the accommodator and the taxpayer enter into a written agreement providing that the accommodator is holding title to the replacement property for the benefit of the taxpayer in furtherance of a Reverse 1031 Exchange.

4. No later than 45 days after title to the replacement property is transferred to the qualified accommodator, the taxpayer identifies the property to be relinquished.

5. No later than 180 days after title to the replacement property is transferred to the accommodator, the title is transferred to the taxpayer.

6. The relinquished property must actually be transferred to the taxpayer's buyer.

Reasons to use a reverse 1031 exchange

(1) The taxpayer has not yet found a purchaser for the property that will be relinquished; (2) the replacement property transaction must close by a certain date to obtain favorable financing or avoid forfeiting a deposit or the like; or (3) improvements need to be made on the replacement property.

Tax ramifications for either type of exchange

Certain requirements must be met in order to defer 100% of the capital gain and depreciation recapture tax liabilities that would otherwise be an obligation upon a sale of investment property.

First, the person must acquire like-kind replacement property that is equal to or greater in value than the relinquished property. Keep in

mind that the value is based on the net sales price, not on the equity in a property. Second, the taxpayer must reinvest all of the net proceeds from the sale of the relinquished property. Third, the taxpayer must replace the amount of old debt that was paid off on the relinquished property with new debt of an equal amount on the like-kind replacement property.

Of course, there are ways to still pull cash out of an investment property without incurring tax liability. Refinancing the debt is one way, although this should be done well ahead of the exchange. Also, the taxpayer may use the 1031 Exchange to defer only a portion of expected tax liability, receiving a portion of the sale proceeds as a "gain" that would be offset by other losses.

If the transaction results in a trade down in value, the 1031 Exchange

will result in only partial deferral of tax liabilities. The amount that is not exchanged for qualified replacement property is called "cash boot" or "mortgage boot" and will generate recognition of capital gains or depreciation recapture tax liabilities.

Conclusion

Because a 1031 Exchange can be

complex, it is important that a taxpayer consult with an attorney or a qualified intermediary or exchange accommodator when first contemplating an exchange to ensure that the 1031 Exchange or Reverse 1031 Exchange transaction results in the tax deferral you are seeking. Competent tax and financial advisors are equally important.

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