Internal Revenue Code Section 1031: Tax Deferred Exchanges

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Introduction

Section 1031 (like-kind exchanges) offer the opportunity to exchange one property for another, and defer (not currently pay tax on) the gain until the new property is later disposed of in a taxable transaction. In addition, there is no limit to the number of times a taxpayer can take advantage of Section 1031 exchanges. Brokers and parties to transactions can use Section 1031 exchanges to their creative advantage when a party would not be willing to sell in a taxable transaction, or when buyers are cash poor but have other business or investment property, or will have no capital gains tax currently due because of Section 1031.

Section 1031 exchanges have been referred to by a variety of names such as: Starker exchanges, like-kind exchanges, delayed exchanges, non-simultaneous exchanges, and tax deferred exchanges. They all basically refer to the same thing, i.e., that tax on any gain can be deferred through an exchange until a future taxable event occurs.

Tax considerations that the taxpayer should consider when determining whether to execute a Section 1031 exchange include the following: (1) in an exchange, the basis of the new property is reduced by the amount of gain which has been deferred; (2) Section 1031 "defers" tax on gain until a future point, but generally does not avoid it; and (3) in some circumstances, it may be better to "Sell" the property, pay the tax, "reinvest" the proceeds, and get a higher basis with more depreciation as opposed to exchanging under Section 1031.

This legal article is intended as an introduction to this dynamic area of real estate brokerage practice. Individuals who are contemplating an exchange should first consult appropriate professionals who are experienced in the tax and financial aspects of Section 1031 exchanges.

Q **1.** ***What does Internal Revenue Code Section 1031 say?***

A Section 1031 says that when property is "exchanged" for other property that is "like kind," some or all of the gain which is "realized" (received) may not be "recognized" (taxed currently). For example, if a taxpayer exchanges one income or business property which has an adjusted

basis of $50,000 and a value of $100,000, for another qualified like-kind property valued at $100,000, s/he has "realized" a gain of $50,000, but it would "not" be currently recognized as taxable, due to the provisions of Section 1031.

Note that Section 1031 cannot be used for property that is personal use property, such as a principal residence. Section 1031 says that no gain or loss is currently recognized if business or investment property is exchanged for other like-kind property which will be held for use in a trade or business, as an investment, or for production of income.

If an exchange is made for property that is both like-kind and not like-kind, as where an apartment building is exchanged for a fleet of trucks and an office building, then some of the gain will be recognized (taxable) by the Internal Revenue Service (IRS). (The trucks are personal property, unlike the apartment building and the office building which are both real property.) In general, all real property will be considered like-kind with all other real property, as long as both parcels are U.S. real property held for use in a trade or business, as an investment, or for production of income. This non-recognition by the IRS is not necessarily permanent. More correctly, the gain is postponed or deferred until a later taxable transaction. (See Question 6).

Q 2. What is the exact wording of Internal Revenue Code Section 1031?

A "Sec. 1031 [1986 Code].

(a) Nonrecognition of gain or loss from exchanges solely in kind.

1. In general - No gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like-kind which is to beheld either for productive use in a trade or business or for investment.
2. Exception - This subsection shall not apply to any exchange of (A) Stock in trade or other property held primarily for sale, . . .(D) Interests in a partnership . . .
3. Requirement that property be identified and that exchange be completed not more than 180 days after transfer of exchanged property: For purposes of this subsection, any property received by the taxpayer shall be treated as property which is not like-kind property if

(A) such property is not identified as property to be received in the exchange on or before the day which is 45 days after the date on which the taxpayer transfers the property relinquished in the exchange, or (B) such property is received after the earlier of

(i) the day which is 180 days after the date on which the taxpayer transfers the property relinquished in the exchange, or

(ii) the due date (determined with regard to extension) for the transferor's return of the tax imposed by this chapter for the taxable year in which the transfer of the relinquished property occurs . . ."

In other words, the following requirements must be met in order for the property to qualify for Section 1031 non-recognition treatment:

- The properties, both transferred (the downleg) and received (the upleg) must be like-kind (for example, both must be real property);
- Both properties must be held for use in a trade or business or for investment and not primarily for sale;
- Both must be tangible (real or personal) property;
- It must be an exchange, not a sale and reinvestment;
- The taxpayer must demonstrate an intent to exchange; and
- If the exchange is not simultaneous, the taxpayer must meet certain time frames for identifying the upleg property and closing escrow. These time frames will be strictly enforced. (See Question 3.)

It is also important that the taxpayer does not have constructive or actual receipt of money, cash equivalent, or any non-qualifying property or have the unrestricted right to direct the escrow proceeds. This warning also extends to the taxpayer's agent. For this reason, some sort of "qualified intermediary" should be used to act on behalf of the exchangor in a delayed exchange. There are strict rules as to identification and receipt of property. (See Question 4 for rules as to identification of the upleg property.) If the various rules are not properly followed, the whole transaction could become currently taxable.

Q **3.** ***What are the time frames for a "delayed" (non-simultaneous) Section 1031 exchange?***

A After disposing of the downleg property, the tax payer must:

- "Identify" the upleg property within 45 calendar days of the transfer of the downleg property. (See Question 4.)
- Acquire (close escrow on) the upleg property no later than the earlier of:

(a) 180 calendar days after the downleg property is transferred, or

(b) the due date (determined with regard to extension) of the tax return for the year in which the downleg was transferred away.

Q 4. *What must a taxpayer do to "identify" the upleg within the 45 day period?*

A A taxpayer must clearly identify in writing the property to be acquired. The identified property must be unambiguously described. Generally, a street address or legal description will suffice.

Under Treasury Regulations section 1.1031(k)-1 a maximum of three target properties without regard to their fair market values may be "identified." (If any becomes unacceptable, a Notice of Revocation is needed.) If more than three properties are desired to be identified, this is allowed if their combined fair market value at the end of the 45 day period doesn't exceed 200 percent of the total fair market value of the downleg properties. If you exceeded 200 percent, the exchange may be deemed fully taxable, subject to the rules affecting property already received before the end of the 45 days . There are additional rules under the regulations that deal with the number of properties a taxpayer may identify that will not be covered here but that should be referred to before executing a Section 1031 transaction.

Q 5. *Can a taxpayer utilize Section 1031 when dealing with an owner-occupied residence?*

A No. However, individuals sometimes exchange one rental property for another planning to move into the acquired property and, after living in it for two years, sell it and take advantage of the capital gains exclusion of $250,000 for individuals and $500,000 for married couples filing joint returns. This had sometimes occurred as soon as three or four years after the acquisition. As of October 22, 2004, this will no longer be possible. Pursuant to the American Jobs Creation Act (signed by President Bush on October 22, 2004), a property acquired in a 1031 exchange and later converted to a principal residence must be owned for five years from the date of the exchange before the owner can claim the capital gains exclusion. So, in order to take advantage of a 1031 exchange and the capital gains exclusion, the owner must both have used it as a principal residence for two years and owned it for five years.

Q 6. *Is it possible for a taxpayer to avoid ever paying tax on the gain deferred in a Section 1031 exchange?*

A Yes. Since there is no limit to the number of Section 1031 exchanges that a taxpayer can be involved in, a taxpayer can continue to defer the taxes due by either holding on to the property or by further exchanging it with other like-kind property until the taxpayer dies. When a taxpayer dies without having sold or transferred the property in a taxable transaction, his/her

estate will not have to pay income tax on the deferred gain. The basis will be "stepped up" to its market value at the taxpayer's date of death. As a result, when the estate or heirs later sell the property, they will only pay tax on the increase in value after the original taxpayer's death.

Q 7. ***Can personal (non-real estate) property be exchanged for other personal property in a Section 1031 exchange?***

A Yes. Personal property can be exchanged for other like-kind (personal) property. (See Question 11.)

Q 8. ***Can a partnership interest be exchanged in a Section 1031 exchange?***

A Generally not. The non-recognition of gain or loss rules do not apply to transfers of most partnership interests. However, a partnership which owns property can exchange the property for other like-kind property in a Section 1031 exchange. Exchanges involving a partnership are very technical and complex. Parties interested in this area should consult a certified public accountant (CPA) or tax lawyer experienced in this specialized field.

Q 9. ***Is there a particular way that a Section 1031 exchange must be structured?***

A No, an exchange can be structured in a number of ways. However, first and foremost, a Section 1031 exchange should be structured by someone who has expertise in this area. The exact structuring of an exchange depends on whether the exchange will be simultaneous or delayed, the business practices of the accommodator, (if any), the preferences of the parties' CPA, attorney, or other tax advisor, and other factors. Structuring an exchange can be complex and should be done only by someone experienced in the tax and financial aspects of Section 1031 exchanges.

Q 10. ***To be eligible for a totally tax deferred exchange, must a taxpayer trade up in equity as well as trade up in fair market value?***

A Yes. The fair market value of the upleg property must be equal to or greater than the fair market value of the downleg property to avoid paying tax on any gain. In addition, a taxpayer must receive equity in the upleg property equal to or greater than the equity given up on the down leg property to avoid any taxable "boot." Therefore, in an exchange, it is the equities of the two properties that are exchanged. The equity is the property market value minus any mortgages, liens or any other encumbrances.

Finding two properties with equal equity is rare. It is possible for one party with greater equity to, for example, take on an additional mortgage in order to make the equities equal. Also, along with the exchange of the properties, one party can give the other notes, cash, a car or other personal property to balance out the equities. In general, a taxpayer should consider exchanging into a property with a higher market value and a higher mortgage than the downleg to avoid paying taxes on any gain. (See Question 12.)

Q 11. ***What is meant by a "like-kind" exchange?***

A Both the property transferred (downleg) and the property acquired (upleg) must be like-kind. This means that real property may be exchanged for other real property, or personal property may be exchanged for other personal property. For real property, any property that is considered real property under State law will qualify for an exchange for other real property, as long as the other requirements are met. (See Question 2.)

For example, an apartment house may be exchanged for raw land that will be held for investment, or a single family residential property that has been held for rental may be exchanged for a shopping center, or any similar combination.

Q 12. ***What is "boot"?***

A If the taxpayer receives some cash or property in an exchange that does not qualify for Section 1031 non-recognition of gain treatment, the non-qualifying portion (unlike property) is called "boot" and will be subject to tax based on the fair market value of the unlike property. Generally, there are three different kinds of unlike property. These are:

1. cash;
2. other unlike or non-qualifying property, which may either be real or personal property (such as a house that the exchangor will occupy as a personal residence); and
3. net mortgage or loan relief.

The mortgage debt of the downleg property is considered unlike property and is subject to tax. However, if the upleg is also subject to a mortgage, the amount which is subject to tax is determined by the net mortgage relief. The unlike property will be the balance of the downleg mortgage in excess of the balance of the upleg mortgage. This rule will apply whether the property is acquired subject to or with an assumption of a mortgage, or with a new mortgage. (See Question 10.)

There can be situations in which a taxpayer has net mortgage relief but also pays cash. In that case, the net mortgage relief may be reduced by the cash paid in determining the net unlike property received (boot). On the other hand, if a taxpayer receives cash and also assumes a loan amount greater than that given up, the taxpayer may not reduce the amount of cash received by the increase in the loan burden. Therefore, the full amount of the cash received will be treated as unlike property (boot) in determining the amount of recognized gain. It is clear that in order to avoid paying tax, boot must be eliminated. This is commonly done by offsetting boot given against boot received. However, all forms of boot may not be offset against each other.

The following are some basic rules:

Mortgage boot received can be offset against mortgage boot given.
Cash and property boot given, can probably be offset against mortgage boot received and/or cash and property boot received.

Cash boot received cannot be offset by mortgage boot given.

Note that one "gives" mortgage boot by assuming an existing mortgage and one "receives" mortgage boot by being relieved of the debt.

Q 13. *What is an accommodator?*

A An accommodator is a term used to indicate the person or corporation who facilitates the exchange. An accommodator has an active role in the execution of the exchange. In general, the accommodator helps with the transfer of title and holds the proceeds. The accommodator should be a party to the escrow, and possibly to the acquisition agreement, too. The taxpayer should enter into an "exchange agreement" (i.e., contract) with the accommodator specifying what the taxpayer requires the accommodator to accomplish and the timing of the accommodator's actions.

Q14. *Can the taxpayer's broker or attorney act as an accommodator for the taxpayer's exchange transaction?*

A As a general rule, under the proposed regulations, a broker or attorney who handles only the Section 1031 transaction for an exchange party may act as an accommodator in the transaction without disqualifying the exchange. However, if the broker or attorney is closely allied or bears a relationship to or has represented the taxpayer more specifically (i.e., standing relationship as broker or attorney for the taxpayer on previous occasions) the broker or attorney will be considered a "related party" and this can disqualify the exchange. Instead, the party should select an expert who is a "qualified intermediary" and an "unrelated party," as defined in the regulations. Some attorneys, CPAs, title companies, or others may act as accommodators.

Q 15. *What should a taxpayer look for in an accommodator?*

A A taxpayer should look for a knowledge of real estate and tax law, and evidence that the accommodator is financially stable. Questions a taxpayer should find answers to, so as to avoid problems later on, include:

How experienced is this person?
Is it a corporation or an individual?
Is it adequately solvent?
How comprehensive is the exchange agreement (contract)?
Who wrote the contract?
How is the fee determined?
Are the parties protected?
What assurance is there that the right party will be paid when it's all over?
What prevents the accommodator from taking the money and running off to Jamaica?
What if the accommodator files bankruptcy or becomes insolvent?
Can the accommodator give you a list of references from other exchanges the

accommodator was involved in?

Due to the fact that an accommodator is intricately involved in an exchange, a party should look for financial stability and experience when selecting an accommodator.

Q16. ***What about the risk of bankruptcy or insolvency by the accommodator?***

A The parties should structure the exchange so that their interest in the property and/or funds is locked in in the event of a bankruptcy, and that other creditors are prevented from affecting the validity of the transaction, such as by having a "perfected security interest" in the property and/or funds, under the Uniform Commercial Code. Other security arrangements are also possible.

If an accommodator files for bankruptcy within 90 days of an exchange, the Bankruptcy Court may be able to set aside the conveyance and reclaim the property as part of the accommodator's bankruptcy estate. If this happens, a party without a perfected security interest or other security arrangement risks losing everything, depending on what assets and liabilities the accommodator has during the bankruptcy. Careful selection of an accommodator can minimize, although not entirely eliminate, the risk of bankruptcy or insolvency. Bankruptcy, and how to avoid its pitfalls, is a complicated area of the law. Questions should be referred to an attorney knowledgeable in this field concerning the consequences of the accommodator filing bankruptcy or becoming insolvent.

Q 17. ***May an exchange party receive interest on the funds placed with the accommodator?***

APursuant to Treasury Regulation section 1.103(k)-1(g)(5) the answer is yes. The regulation provides a "safe harbor" stating that the determination of whether the taxpayer is in actual or constructive receipt of money or other property will be made without regard to whether the taxpayer is, or may be, entitled to receive any interest or growth factor as part of the deferred exchange. The safe harbor applies, however, only if the taxpayer's rights to receive an interest or growth factor are expressly limited as stated in Treasury Regulation section 1.103(k)-1(g)(6). Taxpayers are encouraged to see their tax advisor regarding compliance with the regulations and other specific factors regarding receipt of interest in a 1031 tax deferred exchange .

Q 18. ***What types of property do not qualify for Section 1031 exchange treatment?***

A Non-qualifying property includes cash, stocks, bonds or inventory. If these things make up part of the exchange, the remaining property in the exchange can still qualify for non-recognition treatment, but the non-qualifying property will not, since it is boot. (See Question 12.)

Real estate dealers may not exchange their real estate inventory under Section 1031.

In addition, qualifying property must be "like-kind." (See Question 11.)

Q 19. ***Is there a minimum holding period for the property received in an exchange?***

A The law does not specify a particular holding period, except for exchanges between related parties. However, both the property given up and the property received must be held for productive use in a trade or business, or for investment, or for production of income. As a result, if the exchangor sells the property "soon," the IRS may determine that the property was not acquired for investment or business use, but actually for resale. If the IRS determines that the property was acquired for resale, then the benefits of Section 1031 would be lost, and full tax liability would most likely follow. A similar problem could occur if a rental house is acquired in an exchange and then "soon" converted into a personal residence of the exchangor. Two years is generally thought to be a safe period, but there are no specifics in the law.

If the exchange is between "related parties" (Internal Revenue Code Section 267(b)), and a property received from a related party is disposed of within two years after the transfer, any gain or loss that was deferred at the time of the original exchange will now be subject to tax as of the date it is transferred. An exception to this rule applies if the later transfer is due to the death of the related party, an involuntary conversion, or other circumstances which the IRS accepts as not done with the objective of tax avoidance.

Q 20. ***What is the effect of commissions and other transaction costs paid onthe transfer in an exchange?***

A Costs such as commissions, documentary transfer taxes, escrow fees and other transaction costs paid in connection with the transferred (downleg) property reduce the transaction proceeds, and therefore reduce the amount of current or future (deferred) taxable gain. Costs paid in connection with the acquired (upleg) property are added to the basis of that property.

The IRS has ruled that cash paid for transaction costs is to be treated as cash paid in the exchange transaction. Therefore, the IRS ruling allows any transaction cost paid in cash to reduce any cash received in the exchange in calculating the amount of unlike property received.

Q 21. ***How are losses handled in a Section 1031 exchange?***

A There is no recognition of either loss or gain in a properly structured Section 1031 exchange. Both will be deferred until the property that is acquired is later disposed of in a taxable transaction. If the taxpayer receives unlike property together with like-kind property, gain will be currently recognized, however, no loss from the exchange is recognized.

If the taxpayer gives up unlike property together with like-kind property, loss is recognized to the extent that the adjusted basis of the unlike property (other than cash) transferred exceeds its fair market value. The amount of loss not recognized is reflected in the increased basis of property acquired in the exchange because such property takes as its basis, the basis of the property that was given in the exchange.

Q 22. ***What is a "Starker" exchange?***

A A "Starker" exchange is a Section 1031 exchange in which the transfer of the downleg and the acquisition of the upleg do not occur at the same time. *Starker v. United States* which was decided in 1979, held that it was permissible to get the tax benefits of Section 1031 when the upleg property is acquired after the downleg is disposed of. The Starker case did not specify any time limits on completing the exchange. However, Congress later added time limits for identifying the upleg property and completing the exchange. These time limits are discussed in Question 3.

Q 23. ***What is a "Reverse Exchange"?***

A A reverse exchange is when the taxpayer acquires a replacement (or, upleg) property prior to disposing the relinquished (or, downleg) property.

(Source: Real Property Exchanges § 5.1)

Q 24. ***Why might a taxpayer choose a Reverse Exchange?***

A The following are a few reasons why a taxpayer may choose a reverse exchange:

> The taxpayer may face unexpected delays in his or her ability to complete a transfer of a down-leg property in what was intended to be a simultaneous or deferred exchange.
> The taxpayer may need to complete a desirable purchase prior to being able to market or arrange a transfer of a downleg property in a like-kind exchange.
> By having replacement property unconditionally available for acquisition from a cooperative party immediately after relinquishing the downleg property, the taxpayer avoids any risk of failing to meet the identification or exchange period requirements of IRC §1031(a)(3).
> A taxpayer may wish to have a third-party accommodator acquire and own property on which improvements are being made prior to acquiring the upleg property. In doing this the improvement can be considered part of the real property and thereby receive the tax advantage of the like-kind exchange.

(Source: Real Property Exchanges § 5.1)

Q 25. ***What is a disadvantage of a reverse exchange?***

A The cost. Companies that act as accommodators in 1031 exchanges charge much more for a reverse exchange due to their complexity and uniqueness.

Q 26. ***What is the legal authority for Reverse Exchanges?***

ASurprisingly, judicial authority expressly approving reverse exchanges is limited. The landmark case of Starker v. U.S. (9TH Cir 1979) 602 F2d 1341, is typically relied upon in analyzing the applicability of IRC §1031 to reverse exchanges. In Starker, the court held that IRC §1031

does not require that the exchange of the up-leg and down-leg property to occur simultaneously. Therefore, this case can arguably be applied to reverse exchanges.

(Source: Real Property Exchanges § 5.3)

Q 27. ***What commissions will a real estate broker receive in an exchange?***

A As with commissions in all types of transactions, this is a matter of contract between the broker and the party or parties who will be paying the commission. Commission obligations by one or more of the principals should specify, at a minimum, when commissions will be paid, how much, and to whom. (Under California law, commission obligations must be in writing and signed by the party who will be paying, if the transaction involves the sale, "exchange," or lease for over 12 months, of real property.

In addition, if the property contains one-to-four residential units, the contract which initially establishes or later increases a commission obligation must contain the following language in at least 10-point boldface type: "Notice: The amount or rate of real estate commissions is not fixed by law. They are set by each broker individually and may be negotiable between the seller and broker.")

Q 28. ***Are tax-deferred exchanges permitted under California tax law?***

A Yes. The authority is found in Sections 18043 and 24941 of the California Revenue and Taxation Code which basically follows the federal law.

Q 29. ***Does this legal article contain everything the reader needs to know about Section 1031 like-kind exchanges?***

A No. This article is not an exhaustive analysis of the law under Section 1031. This memorandum is intended to give the reader a basic overview of Section 1031 exchanges. This memorandum is not meant to be used in place of professional advice in any given situation. It is always recommended that the reader seek professional advice before entering into a Section 1031 exchange.

Q 30. ***Where can additional information be obtained?***

A This legal article is just one of the many legal publications and services offered by C.A.R. to its members. For a complete listing of C.A.R.'s legal products and services, please visit **car.org/legal**.

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