Tax Deferred Exchanges for Real Estate (§1031)

Like-Kind Exchanges

- Property must be held for either use in a trade or business or for investment.
- Exchange must be "Like-Kind" to qualify for tax deferral.
- Property classified as realty under state law is "Like-Kind".
- "Like-Kind" refers to the nature or the character of the property, not its grade or quality.
- Improved or unimproved is immaterial.
- Income production is immaterial.
- The exchange must be a reciprocal transfer of properties as distinguished from a sale followed by a re-investment.
- May involve transfer of investment property for trade or business property, or vice versa.
- Foreign property no longer like-kind to U.S. property.

Deferred (Forward) Exchanges

- Taxpayer transfers relinquished property and subsequently receives replacement property.
- Identification Period: Identify property(ies) 45 days from close of sale escrow.
- Exchange Period: Close on purchase of replacement property(ies) 180 days from close of sale escrow.
- Identification requirements must be in writing, signed by taxpayer and contain an unambiguous description of the replacement property.
- Identification must be hand delivered or sent by certified mail before the end of the Identification Period to a Qualified Intermediary (QI) involved in the exchange.
- Identification rules: Three properties of any fair market value (FMV) or any number of properties as long as their aggregate FMV as of the end of the Identification Period does not exceed 200% of the aggregate FMV of all relinquished properties [FMV determined without regard to liabilities secured by the properties].
- If the taxpayer fails to comply with 3-property or the 200% identification rules, the identification will still be considered valid if the taxpayer receives at east 95% of all identified properties before the end of the Exchange Period.
- Qualified Intermediary (who cannot be the taxpayer, a related party or a disqualified person) acts to facilitate the deferred exchange by entering into a written agreement with the taxpayer which obligates the intermediary to (1) acquire relinquished property from the taxpayer (2) transfer relinquished property (3) acquire replacement property and (4) transfer replacement property to taxpayer.
- A disqualified person is an agent of the taxpayer at time of the transaction -- acting as taxpayer's employee, attorney, accountant, investment banker, real estate agent or broker within the last 2 years.
- Transferee's exchange obligation secured by cash needs to be held in a qualified escrow or trust account.

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- Taxpayer may not have right to receive, pledge, borrow, or otherwise obtain benefits of cash held in a qualified escrow or trust account until (1) after the end of the Identification Period if no replacement property is identified (2) after the taxpayer has received all of the identified replacement property to which he/she is entitled (3) if replacement property has been identified but not received , after the end of the Identification Period and the occurrence of a material and substantial contingency that (a) relates to the exchange, (b) is provided for in writing and (c) is beyond the control of the taxpayer or a disqualified person, or (4) the end of the exchange period.

Reverse Exchanges

- Ownership of replacement property transferred to the "Exchange Accommodation Titleholder" (EAT).
- At the time the property is transferred to the EAT, the taxpayer must have bona fide intent that replacement property is intended to qualify for non-recognition of gain associated with exchange under Section 1031.
- No later than 5 business days after the EAT acquires the property, the taxpayer and the EAT must enter into a Qualified Exchange Accommodation Agreement (QEAA). The QEAA must specify that the EAT is holding the property for the benefit of the taxpayer to facilitate an exchange under Section 1031.
- The QEAA must also specify that the EAT is the beneficial owner of the property, and all parties must report ownership of the property as such for federal income tax purposes. EAT cannot take depreciation.
- Taxpayer must identify the relinquished property within 45 days from the date the EAT acquires the parked replacement property.
- Combined period the replacement property is held in the parking arrangement cannot exceed 180 days.
- EAT can also act as Qualified Intermediary.
- Taxpayer can guarantee debt the EAT takes on to acquire the parked property and can indemnify the EAT against costs and expenses.
- Taxpayer can loan funds directly to EAT.
- EAT can lease parked property to the taxpayer (triple net lease).
- Taxpayer can manage the property and oversee construction of improvements on the property.
- The taxpayer and the EAT can enter into agreements arranging for the purchase and sale of the property, including puts and calls and formula pricing.
- The taxpayer and the EAT can enter into an agreement to deal with fluctuations in the price of the relinquished or replacement properly during the period of time the property is owned by the EAT.

Example 1: Basic Exchange Last Replacement Property Parking

- Acquisition and retention: EAT purchases replacement property from third party seller – improvements to replacement property can be made within 180 days

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- Exchange: Taxpayer sells relinquished property to third party buyer through Qualified Intermediary (which can be EAT), and then EAT sells replacement property to taxpayer completing the exchange

Example 2: Exchange Last Replacement Property Parking with Forward Exchange

- Party A owns no investment property
- Party B owns investment property X having FMV of $100k and basis of $80k
- Party C owns investment property Y having FMV of $160k and basis of $60k
- Party D owns investment property Z having FMV of $120k and basis of $90k
- Party D wants to sell property Z and cash out – will incur taxable gain of $30k
- Party C is interested in purchasing property Z but needs to sell property Y
- Party C decides to do a reverse exchange and arranges for property Z to be purchased (parked) by an EAT that is also a Qualified Intermediary
- In the meantime, but unbeknownst to Party C, Party B decides to do a forward exchange wishing to exchange Property X for a more valuable property
- Party B finds Party A to purchase Property X, which is done through another Qualified Intermediary.
- Within 3 weeks of disposing of relinquished property X, Party B identifies Property Y as the replacement property
- Party B completes forward exchange paying $60k cash in addition to relinquished property X
- Party B has no recognized taxable gain on the transaction and now has a tax basis in Property Y of $130k (substituted basis of $80k plus $60k for cash outlay)
- Completion of Party B's forward exchange allows Party C to complete its reverse exchange
- Party C has recognized taxable gain of $30k on the transaction and now has a tax basis in Property Z of $60k (substituted basis of $60k plus taxable gain of $40k less $40k for cash received)

Party	**Property before exchanges**	**Action required**	**Taxable gain**	**Property after exchanges**
A	None	Cash outlay of $100k to QI	None	X (basis of $100k)
B	X (FMV=$100k, basis = $80k)	Cash outlay of $60k to QI	None	Y (basis of $140k)
C	Y (FMV=$160k, basis = $60k)	Arranges for Property Z to be parked by EAT, then sells Property Y and receives $40k	$40k	Z (basis of $60k)
D	Z (FMV=$120k, basis = $90k)	Sells Property Z for $120k to EAT	$30k	None

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