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Real estate investing is similar to playing Monopoly. Winning at either takes savvy and the skill to negotiate the exchange of less desirable properties for more valuable ones. Texas property owners intent on winning should understand the many benefits of Internal Revenue Code section 1031 tax-deferred exchanges.

# 1031 Tax-Deferred Exchanges

## Evolving Rules, Greater Opportunities

By Greg Lehrmann

**T**ax-deferred exchanges have been in the tax code since 1921 and are among the significant tax advantages for real estate investors. The key advantage of a 1031 exchange is that it allows an investor to dispose of a property without incurring a capital gain tax liability. This allows the earning power of the deferred taxes to work for the benefit of the investor instead of the government.

### Creative Exchange Strategies

As tax code rules and cases have evolved overwhelmingly in favor of taxpayers — especially with regard to real estate — exchanges have become easier. A seller hires a 1031 qualified intermediary (QI) to document the sale of a property as an exchange. The QI holds the proceeds to prevent the seller from being in a

relinquished property (if for example, a prime property is listed in a hot market, investors would have to write a contract quickly to compete with other prospective buyers).

Previously, reverse exchanges were used infrequently because the IRS offered no guidance on the topic. Reverse exchanges were considered a gray area, and taxpayers either proceeded with caution or chose to avoid them.

### 'Parking' Properties

In the past, there were three basic approaches to reverse exchanges: the "pure" reverse approach, the *exchange-first* (relinquished property parked) approach and the *exchange-last* (replacement property parked) approach. The first was dismissed by most QIs because the exchanger cannot own the relinquished property and the replacement property at the same time.

The goal was to create an arms-length transaction in which the QI (or an entity created by the QI) acquired either the relinquished property or the replacement property for the taxpayer and created an exchange, which should otherwise fall within the rules and regulations relating to deferred exchanges. The exchange-first and exchange-last approaches became known as parking arrangements because the QI "parks" one of the properties in the QI's name to prevent the exchanger from owning both properties simultaneously.

The problem of constructive ownership arose in these transactions. Although the QI held title to the property, all the benefits and burdens of ownership were transferred to the exchanger.

taxable situation. Potential replacement property is identified within 45 days after closing, and some or all of those properties are acquired within 180 total days after the sale. For real estate exchanges, the properties just need to be used in the exchanger's business or held as an investment. This format is called the *delayed exchange*.

Although the delayed exchange variation is the most common, many exchangers employ more creative strategies, such as *reverse exchanges*. A 1031 reverse exchange is called for when the replacement property must be acquired before closing on the

Questions regarding management of the parked property, loan arrangements, taxpayer advances to fund the acquisition, exit strategy, fixed price versus fair market value and who was to receive the tax benefits of ownership while the property was parked were common. If the taxpayer retained all the burdens and benefits of ownership while mere legal title



was parked, it was feared the taxpayer would be treated as actually owning both the relinquished and the replacement properties at the same time.

## New Rules for Reverse, Improvement Exchanges

**A**fter years of deliberation, the IRS has validated the parking arrangements described previously, as long as the exchange is completed within 180 days. Revenue Procedure 2000-37, enacted Sept. 15, 2000, creates a “safe harbor” for exchanges in which a third party called the “exchange accommodation titleholder” (EAT) enters into a parking arrangement and acquires title to either the relinquished or replacement property. This applies to reverse and improvement exchanges. More on improvement exchanges follows.

The EAT is the entity that parks the property. The EAT and QI can be the same, but preferably the EAT is a separate entity formed by the QI specifically for an exchange. Strategically applied, the new rules offer investors enhanced investment alternatives.

**Seize a Buying Opportunity.** Investors can now immediately acquire a desirable replacement property before selling the relinquished property. Many commercial investors are using this strategy, particularly in markets where inventory of properties is low or turns over quickly. Investors can purchase their next investment property as soon as a good buy is available.

**Guarantee Exchange’s Buying End.** The new rules can reduce the pressure associated with finding a replacement property within the 45-day identification period. Thousands of commercial transactions fail to close each year because investors are unable to locate suitable investments within the 45-day identification period constraints. A replacement property can now be purchased before selling the relinquished property. This transfers the time crunch from the purchasing phase to the selling phase.

**Create an Investment.** Investors can build their investment properties from the ground up or improve an existing property (as long as the property is in the EAT’s name) to create an investment that meets their exact needs. Many Texas investors are using tax-deferred dollars to build new warehouses or office buildings that meet their particular requirements rather than being limited to properties available on the market. This type of exchange provides tremendous flexibility because a certificate of occupancy is not required within the 180-day exchange period to meet the requirements for full tax deferral. The taxpayer can count improvements built and paid for during the 180-day exchange period, whether the project is complete or not.

More investors are combining a reverse exchange with an improvement exchange by purchasing a new property and making improvements to the property before the relinquished property is sold.

## Converting Rental to Residence

Investors can combine the tax deferral benefits of an exchange with the tax exclusion advantages available under the primary residence tax rules (Internal Revenue Code 121). Exchanging into a replacement property that is initially held for investment and

later converted from rental property into a primary residence enables a property owner to obtain tax-free funds.

Under the primary residence tax rules, anyone living in a property as their primary residence for 24 months out of a 60-month period can exclude from taxable income \$250,000 (if filing single) or \$500,000 (if married filing jointly) of the gain from the sale of their home. This exclusion is available once every two years.

## Vacation Homes and Tenants-in-Common

Real estate located in resort or vacation areas may qualify for an exchange if owners can establish that their intent was to hold the property for investment. Property owners in many resort destinations nationwide are deferring 100 percent of their capital gain taxes and exchanging for more desirable properties.

IRS rules have long allowed an owner to sell a whole property and purchase an undivided interest in another property, becoming a “tenant in common” (TIC) with other owners of the real estate.

Increasingly, owners of shopping centers anchored by national tenants like supermarkets are selling fractional ownership interests in such centers. These are called TIC/NNN programs because tenant-in-common interests are sold in centers managed largely by the tenants through triple-net leases.

Investors participate in the benefits of larger commercial projects that often result in a relatively passive investment generating a predictable monthly cash flow. However, each such investment must be closely examined for economic and legal viability.

**R**eal estate cannot be exchanged for personal property, such as a partnership interest or REIT stock. Therefore, a taxpayer must be satisfied that the **substance** of the transaction, and not just the **form**, is still a real estate purchase. On March 19, 2002, the IRS issued Revenue Procedure 2002-22, specifying the conditions under which the IRS will consider a request for a ruling that an undivided interest in rental real estate will be considered an interest in real estate and not an interest in a partnership or “business entity.” While this procedure does not constitute a safe-harbor that automatically validates any program, the advance-ruling requirements are likely to become a litmus test for many sponsors of TIC programs.

Unlike Monopoly players, real estate investors do not have to depend on a roll of the dice to pass go and collect more money. Savvy Texas property owners are using tax-deferred exchanges to acquire desirable Boardwalk and Park Place properties and win the investment game.

This information is not intended to replace qualified legal or tax advisors. Taxpayers should review their specific transactions with their own legal or tax counsel. ♣

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