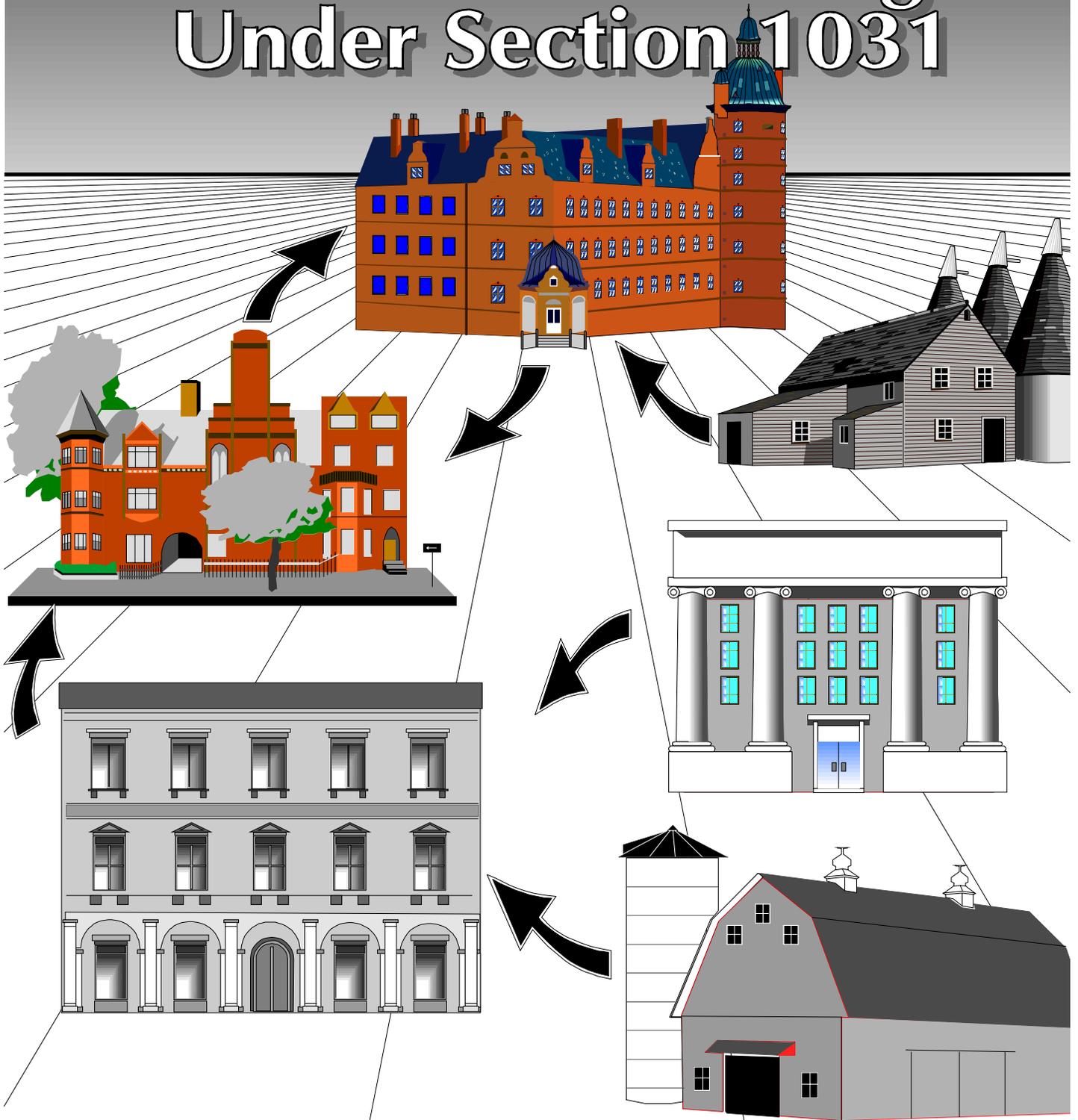


# Real Estate Exchange Under Section 1031



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## Summary

Section 1031 of the federal Internal Revenue Code (IRC) provides real estate owners a way to dispose of property without recognizing accrued capital gains in the year of disposition. The technique benefits investors who want to retain an investment in real property but need to change the specific properties owned. This report reviews the technique in light of current tax law. To illustrate how exchanges work and the effects of the latest code revisions, a benchmark example is followed in a series of cases that build in complexity.

Federal income tax laws consider any increase in an asset's value to be taxable income. However, tax liability is not recognized (*recognized* means that payment is due in the current tax year) until the gain is realized through sale or liquidation of the asset. Therefore, an investor may defer paying taxes on real estate assets for years. When the assets are sold, however, sizable taxes may be due.

If an asset's sale is to restructure an investment, tax liability may be a problem. For example, an apartment investor may want to shift to office properties or to trade a group of small buildings for a larger complex. If resale proceeds are diminished by taxes, the portfolio's value is decreased.

Congress has acknowledged that this situation deters potential transactions. Section 1031 of the IRC provides relief for investors who change the makeup of their portfolio but only with the same kind of asset. The section defines how real property held for trade, business or investment may be exchanged so that taxes due on capital gains are deferred until a *bona fide* sale takes place.

Tax-deferred exchanges under Section 1031 are more common than is thought. Some real estate agents specialize in exchanges, and marketing sessions nationwide attract agents who actively trade properties.

Exchanges can be a simple two-party trade of properties but, more often, are complicated, multiple-party transactions in which some parties either contribute or receive cash only. Within the same transaction, some parties can receive tax-deferred treatment even though other participants do not qualify.

## Basic Requirements for a Tax-Deferred Exchange

To qualify for tax deferral under Section 1031, investors must satisfy the basic requirements of an exchange.

First, a **true exchange of properties** must occur. The mere fact that properties change hands during a transaction is not sufficient to qualify. Disposal of existing property and acquisition of another must not involve transfer of cash or its equivalent (except in the form of additional cash, or *boot*, needed to balance values in exchange). Transfer of properties need not be simultaneous (delayed exchanges are allowed), but the surrender of one property must be contingent upon receipt of a replacement property.

Exchanges between related parties are allowed but are restricted. If the exchanging party transfers property to a related party, the related party must hold the property for at least two years. The exchanging party cannot receive property from a related party, except when there is a mutual exchange of property between the parties.

Second, Section 1031 applies only to **domestic property held for productive use** (such as rental property, an owner-occupied commercial property or a farm) or as an **investment** (such as vacant land). Property that is held as inventory, such as building lots produced by a developer, does not qualify; neither does property acquired purely for resale. In addition, Section 1031 does not apply to personal residences or to foreign real estate.

Finally, **like-kind properties** must be exchanged; that is, real property must be exchanged for other real property. A

vacant tract of land can be exchanged for an apartment complex and qualify under Section 1031. However, a building cannot be exchanged for an automobile or a suite of office furniture. At one time, certain partnership interests could qualify, but these were barred by the Tax Reform Act of 1984. The law is not always clear regarding partial interests, so tax counsel is advised.

A tax-deferred exchange may not always be beneficial to property owners. If a transaction is structured as a like-kind property exchange, however, the Internal Revenue Service (IRS) may treat it as such without election by the parties involved. Therefore, if the taxpayer does not want the transaction to be treated as an exchange, he or she must be careful to structure it as an outright sale.

### Advantages of Tax-Free Exchange

**Retains more funds for investment.** By deferring taxes on capital gains, an exchange allows the investor to reinvest more of the proceeds from disposition of the former property. This is especially beneficial when pyramiding appreciating assets into growing portfolios.

**Postpones tax payment.** A delayed tax payment is like an interest-free loan from the government. Given constant tax rates, the tax liability's nominal value is unchanged. This means that the longer the payment is delayed, the lower the present value of the taxes and the larger the benefit of the deferral. In fact, if taxes are delayed long enough, they may never need to be paid. When property is transferred at death, the basis may be adjusted to current market value. Under such circumstances, all deferred capital gains tax liability is eliminated and is not transferred to the estate's heirs.

**Provides possible access to tax-locked properties.** A property held for many years may have a tax basis near zero (the result of depreciation deductions). Because most of the sales price would be recognized as a capital gain, selling such property could prove expensive. To avoid immediate tax payments, owners may be more willing to exchange than to sell. An investor may find additional opportunities with an exchange rather than a cash purchase or sale.

### Disadvantages of Tax-Free Exchange

**Exchanges are complex.** Difficulties in matching parties for a mutual exchange and stringent timing requirements may decrease exchange transactions. An exchange must be properly structured and documented. All details must be in order to allow for a timely exchange.

**Tax basis may be reduced.** An exchange property may have a lower tax basis as a result of tax deferral than the same property purchased outright. Thus, not only could capital gains taxes at some future disposition be higher, but the basis for annual tax depreciation is reduced, making the acquired property less valuable as a tax shelter. This drawback has been mitigated by the reduced depreciation allowances and lower marginal tax rates available since 1986.

**Future taxes may be higher.** A succession of tax-deferred exchanges reduces the adjusted tax basis and raises the capital gains recognized on a subsequent sale. Under a progressive tax schedule (higher tax rates on

higher incomes), enlarged capital gains may be taxed at a rate higher than that for earlier recognition. In addition, marginal tax rates may be higher in the future.

**Loss is not recognized.** In an exchange, recognition of any loss is deferred just as is a gain. In most cases, a taxpayer wants immediate recognition of a loss. For this reason, exchanges in general are not recommended for property that has declined in value.

A property owner should compare the consequences of an exchange to the alternative of outright sale and purchase of other real estate. In particular, one should look at the impact on cash costs of the transaction, the tax liability that is generated and the tax basis on the property acquired. The next section shows how to do such an analysis.

## Structuring and Evaluating an Exchange

The accounting procedures for exchanges are straightforward, requiring little accounting skill or financial knowledge. This section describes how to structure a set of accounts to derive the necessary critical indicators in exchange analysis. Included are procedures for balancing equities, calculating the gain realized from property disposition, calculating recognized gain and calculating the tax basis in the acquired property. Later examples illustrate various issues and complications that can arise.

### Balancing Equities

In a two-party exchange, each party receives property of equal value. In a simple exchange, the fee simple interest in one property is exchanged for a fee simple interest in another. Thus, the market value of the two properties must be the same. (As in any arms-length transaction, the *value* of the property is whatever the two parties agree upon.) When little or no cash is involved, the price of the properties cannot be measured directly, yet the price affects the transaction's tax consequences. An appraisal is recommended to support value representations used in any exchange analysis.

In real life, most exchanges are more complicated. When the values of the like-kind properties are not equal, one party must provide additional consideration, or *boot*, to balance the exchange. Boot is any property that is not like-kind in the exchange: cash, personal property, real estate that does not qualify or mortgage indebtedness transferred with the property contributed.

When mortgages are exchanged with the properties, the value of the equity (value minus outstanding debt) must be equalized using the following tabulations:

	First Party	Second Party
Value, like-kind property		
Less: Mortgage debt	_____	_____
= Equity		
Plus: Cash		
Plus: Value of other property	_____	_____
= Value of property received		

## Gain Realized

The realized gain is the capital gain from the transaction, which can be partially or totally deferred for taxation purposes in a qualified exchange. As in a sales transaction, the realized gain is the difference between the value of property received and the adjusted basis of property given. In an exchange, the value received is the total of the value of like-kind property received plus any cash or value of other property received *less the costs of the transaction*. The adjusted tax basis is the original basis of the property contributed minus any accrued depreciation taken during ownership.

Value of like-kind property received	_____	
Less: Mortgage assumed	_____	
= Equity received		_____
Plus: Net cash received	_____	
Plus: Value of other property received	_____	
= Value of property received		_____
Less: Commissions paid on exchange	_____	
Less: Adjusted tax basis of real estate contributed	_____	
= Realized gain		_____

## Recognized Gain

The value of a 1031 exchange lies in the difference between realized gain (the gain actually achieved through the transaction) and recognized gain (that amount of gain taxed in the year of the transaction). The difference between these two figures is the gain deferred from taxation.

If an exchange qualifies for 1031 treatment, gain is recognized to the extent that the taxpayer receives net boot. Any boot that is contributed in the exchange can be used to offset boot received (the exception is mortgage indebtedness relief, which can never be negative; the concept of mortgage relief is discussed with examples in "Exchange with Boot"). A simple tabulation is used to calculate net boot:

Net mortgage relief	_____
Plus: Cash received	_____
Less: Cash contributed	_____
Plus: Other property received	_____
Less: Other property contributed	_____
= Net boot received	_____

The gain recognized for taxation is the **lesser** of net boot received or the actual gain realized. When net boot is zero, the transaction is completely tax-deferred. If net boot exceeds realized gain, no tax benefit results from the exchange. Never will the gain recognized be larger under a qualified exchange than under a sale.

## Adjusted Tax Basis

The tax basis of the like-kind property received is reduced dollar-for-dollar by the amount of gain deferred.

If the property later is sold, the gain recognized will be increased by the amount of gain deferred because the tax basis will be lower. (The down side of tax deferral is the possibility that a future sale might create a positive capital gain even though no cash proceeds are received. This would occur if the property's value declined to or below outstanding mortgage debt, yet remained more than the adjusted tax basis.)

When a property is purchased, the tax basis of the property is its acquisition cost. A like-kind property obtained through exchange requires one more step. The value of the property is reduced by the difference between the gain realized and the gain recognized. A series of examples will be reviewed to illustrate how these calculations are made.

## Exchange Examples

Although the concept of exchange is simple, related issues complicate its application. The cases presented begin with a basic exchange and introduce complexities gradually.

### Even Exchange

Brown owns ten acres separated from his main farm by a highway, which creates access problems. Green wants this land and offers ten acres adjacent to Brown's farm in an even exchange. They agree and call an attorney to prepare the papers.

Brown inherited the ten-acre parcel, which was valued at \$100 per acre when the estate settled. Green paid \$20 an acre for his farm. If land values currently are \$350 an acre, each party would have a sizable capital gains liability unless the exchange could qualify for 1031 treatment. All qualifications are met. The properties are like-kind, the transaction is a *bona fide* exchange, and the properties were held for productive use.

At current prices, each property is valued at \$3,500. Each is owned free and clear with no mortgage lien. Because the parties agree to an even exchange, additional consideration is unnecessary. However, each party will have a different tax result because of the difference in basis.

Brown has a tax basis of \$1,000, the value of the property upon inheritance. His realized gain is the difference between the exchange value (\$3,500) and the basis (\$1,000) or \$2,500. Green's basis is the original cost: \$20 per acre, or \$200 for the ten-acre plot. His realized gain is \$3,500 minus \$200, or \$3,300.

Because the only consideration exchanged in the transaction was the like-kind properties, all gain can be deferred. The gain recognized (taxable) by either party is zero. The deferral of gain recognition is reflected in the tax basis that carries over to each property in the exchange. Brown has a basis of \$1,000 in his new property, while Green records his new basis at \$200. If they had purchased the properties for cash (even if the cash had merely passed back and forth across the table at closing), they each could have set their basis at \$3,500. In exchange, their new basis is diminished by the amount of gain deferred.

## Exchange with Boot

*Boot* is anything other than like-kind property that is included in the exchange. Essentially, any gain realized is taxed to the extent of any net boot received.

For example, suppose Green's land was worth \$4,500. Brown adds cash to the deal to balance the trade. The exchange now looks like this:

	Brown	Green
Land value	\$3,500	\$4,500
Cash	<u>+1,000</u>	_____
Total exchanged	\$4,500	\$4,500

Because Brown does not receive any boot, the exchange still is completely tax-free for him. However, Green has a realized gain of \$4,300 (\$4,500 value minus the \$200 basis), \$1,000 of which must be recognized on the current year's tax return. The \$1,000 represents the cash boot received as part of the exchange. Green defers \$3,300 in realized gain, and his basis in the land acquired is reduced by this amount (his basis is still \$200).

Boot can be created when mortgage debt is transferred along with like-kind property. Suppose each land parcel has outstanding mortgage debt and the loans are exchanged along with the land. Brown's loan balance is \$1,500 and Green's is \$2,000. When mortgaged property is exchanged, the value of the equity position is used to balance the trade. One party must supply cash to equate the two positions:

	Brown	Green
Land value	\$3,500	\$4,500
Mortgage	<u>-1,500</u>	<u>-2,000</u>
Equity	\$2,000	\$2,500
Cash	<u>+500</u>	_____
Total	\$2,500	\$2,500

The mortgage debt does not affect the calculation of realized gain. Brown's gain still is \$2,500 and Green's is \$4,300. However, net boot calculation changes. The first step is to calculate each party's net mortgage relief. Mortgage relief never can be negative, so if a party takes on additional debt in the exchange, the net debt relief is zero:

	Brown	Green
Mortgage transferred	\$1,500	\$2,000
Mortgage assumed	<u>-2,000</u>	<u>-1,500</u>
Net debt relief	\$ 0	\$ 500

Net debt relief is considered boot:

	Brown	Green
Net debt relief	0	\$ 500
Cash received	<u>0</u>	<u>+500</u>
Net boot received	0	\$1,000

Brown may defer all gain while Green must recognize \$1,000 of gain corresponding to the amount received in net boot.

*Note:* Suppose Green's property was mortgaged for \$3,000 instead of \$2,000. This would provide Green with equity of \$1,500 available in exchange and would require Green to pay Brown \$500 in cash boot. Thus, Brown would recognize \$500 of gain for the transaction, even though he is taking on a larger debt.

Prior to the exchange, Brown might refinance the land with a \$2,000 mortgage (providing Brown with \$500 in proceeds). Now no boot is required, and Brown may defer all realized gain. Unfortunately for Brown, the IRS anticipated such a maneuver and, under regulations issued in 1990, could nullify the effects of the refinancing if it finds that the refinancing was done merely for the benefit of the transaction.

## Exchange with a Sale

Often, in an attempted mutual exchange, one of the parties does not want the property offered by the other. However, an exchange transaction is not restricted to two parties. Any number can enter an exchange. Not all parties need to exchange property for the transaction to qualify under Section 1031 and for tax benefits to accrue to some parties in the transaction.

Returning to the example, suppose Brown is not interested in the tract that Green offers. Green is willing to pay cash for Brown's land, but Brown does not want to sell because of the tax liability. They call an exchange broker to work something out.

The broker finds pasture land, adjacent to Brown's farm, that appeals to Brown. Its owner, White, is willing to sell the land for \$1,750 plus assumption of an existing mortgage debt of \$2,500. To complete the exchange transaction, Green buys White's land for \$1,750 and trades it plus another \$250 to Brown for his land:

	Brown		Green		White	
	Gives	Receives	Gives	Receives	Gives	Receives
Value	\$3,500	\$4,250		\$3,500	\$4,250	
Debt	<u>-1,500</u>	<u>-2,500</u>		<u>-1,500</u>	<u>-2,500</u>	
Equity	2,000	1,750		2,000	1,750	
Cash	_____	<u>+ 250</u>	<u>2,000</u>	_____	_____	<u>1,750</u>
Total	\$2,000	\$2,000	\$2,000	\$2,000	\$1,750	\$1,750

Note that Brown is the only party that exchanges property. Green is a buyer and White a seller. Nevertheless, Brown is entitled to the advantages offered by Section 1031 regardless of the results for other parties. This is because at no point in the transaction did Brown receive cash (other than the \$250 boot). Green could not have given Brown the \$2,000 cash price of his land as an intermediate step in the transaction (nor could Brown have been granted the right to accept the cash as part of the deal). The issue of *constructive receipt* of income is critical and will be discussed in more detail in later cases dealing with delayed exchanges.

Green disposed of no property and, therefore, has no gain. White's situation is treated as a sale, and her

realized gain must be recognized for tax purposes. Brown has no debt relief (he took on a larger mortgage debt) but did receive cash boot of \$250. Of the \$2,500 gain realized, Brown must recognize a capital gain in the amount of the boot, \$250. His adjusted basis in the property received is reduced from its acquisition price of \$4,250 by the gain deferred through exchange, \$2,250. The resulting basis is \$2,000.

## Multiple Exchanges

In the last example, Green had land he was willing to exchange, but, because there was no taker, he paid cash for his acquisition. Suppose that White is interested in the Green property. A three-party transaction can be constructed in which everyone is eligible for 1031 treatment.

The basic equity balancing table is shown below. Note that White must pay \$750 in cash to balance the transaction. This money is distributed between Brown and Green to equalize their share in the transaction.

	Brown		Green		White	
	Gives	Receives	Gives	Receives	Gives	Receives
Value	\$3,500	\$4,250	\$4,500	\$3,500	\$4,250	\$4,500
Debt	<u>-1,500</u>	<u>-2,500</u>	<u>-2,000</u>	<u>-1,500</u>	<u>-2,500</u>	<u>-2,000</u>
Equity	2,000	1,750	2,500	2,000	1,750	2,500
Cash	_____	<u>+250</u>	_____	<u>+500</u>	<u>+750</u>	_____
Total	\$2,000	\$2,000	\$2,500	\$2,500	\$2,500	\$2,500

Each party has a capital gain from the transaction. Brown's gain is \$2,500 (\$3,500 minus \$1,000 basis); Green's is \$4,300 (\$4,500 minus \$200); and White's is \$750 (\$4,250 minus \$3,500). The amount deferred depends on net boot received:

	Brown	Green	White
Debt relief	\$1,500	\$2,000	\$2,500
Debt assumed	<u>-2,500</u>	<u>-1,500</u>	<u>-2,000</u>
Net relief	0	500	500
Cash received	+ 250	+ 500	0
Cash paid	<u>0</u>	<u>0</u>	<u>-750</u>
Net boot	\$ 250	\$1,000	\$ 0

Brown recognized a \$250 gain, deferring the remaining \$2,250. His adjusted basis in the new property is the value as established by the transaction—\$4,250 minus the deferred gain or a total of \$2,000. Similarly, Green pays taxes on a \$1,000 gain, deferring \$3,300. His new basis is still \$200 (\$3,500 value minus \$3,300 deferred gain). White recognizes no gain and has an adjusted basis of \$3,750 (\$4,500 minus \$750).

## Multiple Properties

Exchanges often are used to consolidate properties. In other words, one party may trade several properties for one property to eliminate scattered holdings and to facilitate management.

Suppose in the example that Brown has a small rental house several miles away in addition to the unwanted land described earlier. Green is not interested in the

house, but another party, Gray, is willing to trade a small recreational lake adjacent to the Brown property for Brown's house. The house is valued at \$15,000 and has no mortgage. The Gray property is valued at \$10,000 and is not encumbered. The exchange is structured as follows:

	Brown		Green		White	
	Gives	Receives	Gives	Receives	Gives	Receives
Value	\$3,500	\$4,500	\$4,500	\$3,500	\$10,000	\$15,000
	+15,000	+10,000				
Mortgage	<u>-1,500</u>	<u>-2,000</u>	<u>-2,000</u>	<u>-1,500</u>	<u>0</u>	<u>0</u>
Equity	17,000	12,500	2,500	2,000	10,000	15,000
Cash	_____	<u>+4,500</u>	_____	<u>+500</u>	<u>+5,000</u>	_____
Total	\$17,000	\$17,000	\$2,500	\$2,500	\$15,000	\$15,000

Gray must add \$5,000 in cash to balance the trade, which is distributed to both Brown and Green. To calculate net boot, the like-kind properties are combined:

	Brown	Green	Gray
Debt relief	\$1,500	\$2,000	\$ 0
Debt assumed	-2,000	- 1,500	0
Net relief	0	500	0
Cash received	+4,500	+ 500	0
Cash paid	0	0	-5,000
Net boot	\$4,500	\$1,000	\$ 0

## Deferred Exchanges

*Deferred or delayed exchanges* allow for non-simultaneous property exchange. They exist because of several tax court decisions. In one case, a landowner agreed to transfer land to a company for the promise of acceptable property in the near future. Although the IRS challenged the treatment of the transaction under Section 1031, the tax court pointed to the lack of specific time requirements in the law. So-called *Starker exchanges* (named after the original landowner in the suit) followed this precedent. The Tax Reform Act of 1984 officially sanctioned delayed exchanges by providing specific time requirements for non-simultaneous exchanges. Code revisions approved in 1991 provide guidelines for delayed exchanges.

The next cases illustrate how delayed exchanges work within the guidelines of the code and how the new regulations provide procedures for avoiding pitfalls.

## Exchange Timing

Returning to the baseline example, suppose Green agrees to acquire Brown's property but has no like-kind property acceptable to Brown. Brown wants a tract of land adjacent to his farm to facilitate his farming operations. Green knows the owners of several plots that fit these specifications, but time is needed to arrange a sale and transfer to Brown. The two farmers could agree orally to an exchange when Green has made the necessary arrangements, but this action requires a great deal of trust on everyone's part. Brown might find a buyer or another

exchange in the interim. Conversely, Green may abandon the arrangements.

A qualified delayed exchange could solve the problem. Brown agrees to transfer his property to Green immediately in exchange for Green's pledge to acquire suitable property. Suitable property must be transferred within 180 days after the initial transfer. In this case, the initial transfer is concluded on November 1, 1992. Green must identify replacement property within 45 days of the transfer of Brown's property (in this case, the deadline for identification is December 16). Green finds a property in early December and sends Brown a legal description of the property to be transferred. Brown agrees and signs a letter of identification before the deadline.

Green then completes the acquisition of the replacement property. In this case, the deadline for the final transfer and exchange is April 15, 1993, when Brown's tax return is due. However, should Brown decide to apply for an extension on the tax return, the deadline could be moved back to April 29, 1993, ending the 180-day period allowed to complete the transfer. Such tactics are needed in this case, as the transfer is concluded in January 1993.

### Designation of Multiple Properties

Suppose Green finds a number of suitable replacement properties for Brown. Brown wants to inspect each property before deciding, but the 45-day identification period is too short.

The law allows Green to identify a number of alternative replacement properties within the 45-day limit, as long as Brown selects one or more to inspect, and the transfer is made within the overall limit on the delayed exchange (180 days). However, there are two restrictive choices:

- no more than three alternative properties can be identified, or
- any number of properties can be identified as long as the total fair market value of the group does not exceed 200 percent of the value of Brown's property transferred to Green.

In other words, Green may select three properties for the exchange or any number of properties with a total market value of \$7,000 or less.

Green uses the three-property rule because each property was worth more than Brown's tract individually. (Although it does not fit this example, Green could have identified any number of properties with unlimited value if Brown takes possession of the property within the identification period.)

*Note:* An identification of property may be revoked at any time prior to the end of the prescribed period. Revocation requires a written, signed document as did the original identification. Once a proper revocation occurs, a new property can be identified as long as the 45-day period has not expired.

### Safe Harbors

Even though the exchange is completely described by legal documents, Brown transfers title to his property for a mere promise of replacement property. Furthermore, both Brown and Green agree that, should the exchange fall

through, the transaction would be completed as a sale. Therefore, Green agrees to place enough cash to purchase Brown's property in an escrow account as security for the transaction.

At this point, the exchange agent identifies potential dangers of this approach. First, the account must be handled carefully to avoid having the exchange disqualified from the provisions of Section 1031. Proper methods for depositing cash in a *safe harbor*, without jeopardizing favorable tax treatment, are provided in the Code.

The basic idea of a safe harbor is a deposit that protects the exchanging party, yet does not allow the party to benefit from the cash in any way during the transaction. First, the escrow account must be held by a party who is beyond Brown's control. This disqualifies Brown, any person related to Brown, the agent hired to do the exchange (an exception allows the agent to act as an intermediary if this transaction is the only one in which the agent has represented Brown in the preceding two years), or any other employee or agent of Brown from the initial transfer of property until the exchange is completed. There are companies, generally associated with title insurance companies, that provide intermediary services and are well-versed in the law and regulations of exchanges.

Second, the account must be set up specifically to restrict Brown's access to the cash or any benefits associated with the cash, such as pledging the account as collateral for financing. Such restrictions can allow Brown to receive the funds only if:

- no property is identified within the 45-day identification period;
- Green states that identified property can not be delivered within the 180-day exchange period; or
- the identified property has been transferred (for example, if cash boot were to be included).

If these rules are not strictly followed, Brown may not be eligible for tax deferment on the transaction.

While lining up replacement property in the exchange, Green may have to acquire title to property that ultimately will belong to Brown. This may require Green to pay certain transfer taxes on the transaction and expose him to potential liability if environmental hazards are later found on the property. To avoid these problems, the parties may use a qualified intermediary as a substitute for the safe harbor escrow.

The intermediary receives sufficient money from Green to acquire replacement properties. The intermediary then arranges acquisition of the properties and respective transfer to Brown. The exchange handled in this manner qualifies for tax deferment even though neither Green nor the intermediary actually takes title to the replacement properties.

Two key restrictions apply. First, Brown's right of access to any funds controlled by the intermediary must be restricted in the manner described for the safe harbor escrow. This restriction must be documented. Second, the intermediary cannot be an agent or a relative of Brown at the time of the exchange.

### Growth Factors

Up to six months may elapse between Brown's transfer of his property to Green and Brown's receiving title to the

replacement property. If the like-kind property involved produces rental or other income, or if property values are increasing, Brown's property may lose income or value during the exchange period. This problem can be handled by including a *growth factor* in the exchange agreement.

For example, Green may agree to compensate Brown for the value of crops harvested from Brown's former property during the exchange period as long as two matters are accommodated. First, the funds from the growth factor must be placed in the safe harbor provided in the exchange. Brown cannot access the funds in safe harbor during the exchange period. Second, the money is separated from the exchange. Funds or property to cover the growth factor are not counted as like-kind property (when compensation is in the form of additional like-kind property) or as cash boot. Rather, it becomes interest income to Brown and is reported as separate income for tax purposes.

## Reverse Exchange

Suppose that the situation is reversed. Brown wants to acquire Green's property, but Green is not interested in the Brown parcel. Brown would like to tie up the Green land while he tries to find a buyer for his land and, thereby, complete the exchange. Such a transaction is considered a "reverse delayed exchange" because the exchanger, Brown, receives replacement property prior to releasing his current property in the exchange.

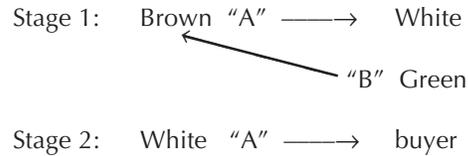
Such a transaction seems to fit into the framework of a delayed exchange because Brown and Green have merely exchanged the roles they played in the previous case. However, Green is not seeking the tax benefits of section 1031. Should Brown take the position of relinquishing property on a delayed basis, he may not be able to defer taxation on the capital gains realized in the transaction.

The problem is not with Brown's intentions or the net result of the transaction. The 1984 revisions to section 1031 were written to legitimize and set boundaries on the type of exchange authorized by the Starker decision. The drafters of the law did not envision a transaction like the reverse exchange and did not provide rules for its practice. If the IRS and tax court allowed reverse exchanges to go unchallenged, none of the time-frame and other rules pertaining to delayed exchanges would apply. Such acquiescence would open the door for avoiding the restrictions placed on delayed exchanges.

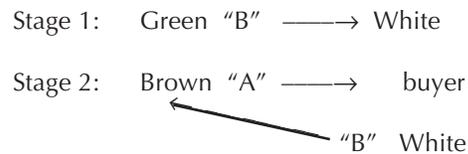
Because a straightforward reverse exchange is not within the purview of current tax law, several procedures have been used to achieve the same result. One approach is to "park" the property with an intermediary until the exchanger is ready to release it. Two types of parking transactions will be illustrated in the next section. An alternative that does not rely on an intermediary uses a lease-option to buy to delay the exchange. An example of this type of transaction is included also.

**Parking 1.** Brown holds property "A" and wants to exchange it for property "B" held by Green. Green does not want to exchange but is willing to sell property "B." Furthermore, Brown wants to acquire "B" immediately, but needs time to find a buyer for "A." Brown recruits a trusted colleague, White (who is unrelated to Brown and is not an agent or employee), to act as an intermediary in

the exchange. In the first stage of the exchange, Brown transfers "A" to White while Green transfers "B" to Brown. White compensates Green in cash or some other form of satisfaction. When a buyer is found for "A," White then transfers the property to the buyer and the buyer compensates White to complete the second stage of the exchange.

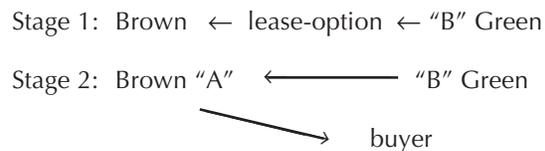


**Parking 2.** Brown could ask White to acquire "B" as the first stage of the transaction. When a buyer for "A" is found, Brown then gets "B" from White while transferring "A" to the buyer.



Transactions of this type must be handled very carefully to avoid violations of the safe harbor rules for delayed exchanges (see following section on "Related Parties") and the constructive receipt provisions governing all types of exchanges. The role of the intermediary is critical and care must be taken to assure White is qualified under section 1031(f). The other critical point is the way Green is compensated in the first stage of the transaction. For a more detailed discussion of these issues, see the article by Terence Cuff listed in the references.

**Lease-Option.** Brown does not want to use an intermediary. Instead, he arranges to lease property "B" from Green with an option to buy the property for a set price within the one-year lease term. In the meantime, Brown searches for a buyer of "A." When found, the exchange is completed by Brown exercising his option to buy "B" while "A" is sold to the buyer. The problem with this arrangement is structuring stage 2 as a bona-fide exchange, rather than two unrelated sales transactions.



## Other Considerations

The following examples illustrate some ramifications of recent rule changes for exchanges.

### Related Parties

Smith owns an apartment building that has been fully depreciated (the adjusted basis is equal to the value originally attached to the land). She wants to sell the property to help her parents with medical expenses. Her

parents own an extensive tract of land, but the family does not want to lose control of it. The basis of the land is roughly equal to its market value. Smith exchanges her building for her parents' land, after which the building is sold. The exchange involves no boot and is totally tax deferred under Section 1031. After the exchange, the basis of the building is adjusted upward to its market value, as indicated in the exchange. The building is sold at a small capital gain.

Changes in the law were enacted in 1989 to prevent cases like the above. If this transaction were conducted under the new rules, Smith would be liable for all taxes deferred in the exchange after her parents sold the building acquired in the exchange. This rule applies to any 1031 exchange conducted between related parties, including closely held corporations, when any property involved in the exchange is sold within two years of the exchange. However, the two-year restriction does not apply when:

- the exchange does not result in non-recognition of gain or loss for either party;
- the property is sold after the death of one of the parties (for example, in the process of settling an estate);
- the property is relinquished in an involuntary conversion, such as a condemnation proceedings;
- neither the original exchange nor the subsequent disposition was transacted for the primary purpose of avoiding taxation.

If either of the related parties disposes of acquired property in a manner not covered by these exemptions, non-recognition of gain in the original exchange is cancelled. Any additional tax liability created by this action is paid in the year of the property disposition. There is no need to file amended returns for the tax year in which the exchange occurred.

## Depreciation Methods

When a realized gain is deferred in a 1031 exchange, the basis of the property acquired is decreased by the amount of gain deferred. However, because depreciation methods have been modified several times since 1981, a question arises as to the method that should be applied to the adjusted basis in the property acquired. The IRS ruled previously that when a property subject to accelerated cost recovery system (ACRS) is exchanged for another property subject to ACRS, a portion of the basis in the acquired property can be recovered during the remaining years of the capital recovery period. Unfortunately, when ACRS property is exchanged for property subject to the modified ACRS (MACRS) instituted after 1986, the taxpayer must convert to the MACRS system to depreciate the adjusted basis.

For illustration, suppose Jones exchanged a property put into service in 1982 under ACRS with a 15-year capital recovery period. The property is valued at \$100,000 and has an adjusted basis of \$25,000. Therefore, Jones' realized gain is \$75,000, which is eligible for non-recognition through the exchange.

Jones acquires a property valued at \$140,000 in the exchange. Her basis in the new property is \$65,000

(\$140,000 less the deferred gain of \$75,000). Suppose the property acquired was eligible for ACRS with a 19-year recovery period. Jones could recover \$25,000 of basis under ACRS during the six years remaining in the period used for the former property. The remaining \$40,000 of basis could be recovered under ACRS during a 19-year period.

Now suppose the acquired property had been put into service after 1986 and was subject to MACRS. Jones must treat the exchange as a disposition of the ACRS property and recover the entire \$65,000 basis of the new property under MACRS during 31½ years (or 28½ years if it is residential property). In addition, Jones must treat the year of the exchange as the first year of the new recovery period rather than as the next year of the ACRS period.

Tax-deferred exchange can be a valuable portfolio-adjustment method for many investors. However, the investor should be aware of how the method is applied and the potential pitfalls involved. This report introduces the technique and illustrates many of the important variations in 1031 exchanges. The examples incorporate significant tax code changes that have been finalized recently. In many ways, these changes have made Section 1031 use more clear-cut but more restrictive. As always, any investor or property owner contemplating a transaction should seek competent counsel and accounting advice before proceeding.

## Additional Reading

This report was based in part on the following references. Readers interested in more detail should consult these articles.

- American Bar Association, Section of Taxation. "Report on the Application of Section 1031 to Reverse Exchanges." *Journal of Real Estate Taxation* (Fall 1993), pp. 44-49.
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