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TAX-DEFERRED EXCHANGES

Tax-deferred exchanges, commonly called 1031 exchanges (referring to the Internal Revenue Code [IRC] section defining them), give property owners the opportunity to dispose of their existing investment property and acquire new replacement property through an exchange rather than a sale. If properly done, the property owner can defer (but not avoid) the capital gains tax that would otherwise be owed on any profit made from a straight sale transaction. This article addresses a typical delayed exchange of real property, not a simultaneous exchange in which the existing and new properties are transferred concurrently.

This article does not deal with exchanges of personal property held for investment or for productive use in a trade or business, nor with the more complicated exchanges, such as reverse exchanges (in which the new property is acquired before disposing of the existing property) or build-to-suit exchanges (in which exchange funds from the sale of the existing property are used for the construction of replacement property), nor does it deal with partnership, limited liability, or Real Estate Investment Trust (REIT) issues. Readers should be aware that special rules apply to exchanges between related parties as defined in the IRC. Also, the complexities of refinancing in connection with an exchange are not covered.

TERMINOLOGY

Understanding the terminology in a 1031 exchange is essential because the definitions include many of the rules to qualify an exchange for tax deferral. The relevant terms are defined as:

Exchanger (or exchangor): The property owner who elects to use a 1031 exchange. This is the seller in an earnest money agreement or purchase and sale agreement. The IRC uses the term "taxpayer" rather than exchanger.

Relinquished Property: The property that is transferred by the exchanger in an exchange. This is sometimes called the exchange property or downleg property.

Replacement Property: The property that is acquired by the exchanger. This is sometimes called the acquisition property or upleg property. The replacement property can be one or more properties.

Like-Kind Property: To qualify as a 1031 exchange, the relinquished property must be exchanged for "like-kind" replacement property. Generally, real property is like-kind as to all other real property, whether improved or unimproved and whether located in Oregon or another state. Bare land and farm land, residential and commercial rental properties, office buildings, industrial properties, and even a leasehold interest of not less than 30 years all qualify for exchange, and each type of property can be exchanged for any of the others. Personal property is not like-kind to real property for exchange purposes, such as that associated with hotels, restaurants, and assisted living facilities.

To qualify as a like-kind exchange, both the relinquished property and the replacement property must be held by the exchanger for investment purposes or for "productive use in their trade or busi-

ness." The exchanger's intention must be to hold the property as an investment or for business purposes. Property held primarily for sale, including real estate held by a developer or dealer, does not qualify. Interests in a partnership or limited liability company cannot qualify for exchange because they are considered personal property, even though the entities themselves may own and exchange real property in a qualified 1031 exchange. Stocks, bonds, promissory notes, other securities, and other evidences of indebtedness also do not qualify. A vacation home does not qualify for exchange because of personal use, but it could be converted to a legitimate rental property and thereby qualify, subject to applicable IRC and Revenue Ruling requirements.

Boot: Property received by the taxpayer in an exchange that is not like-kind. Boot is non-qualified property received in an exchange, such as cash, promissory notes, securities, personal property (e.g., office supplies, furniture), and/or debt reduction. The receipt of boot by an exchanger does not disqualify the exchange, but the market value of the boot is recognized as immediate gain rather than being deferred. Common traps resulting in the receipt of boot are relief from debt on the relinquished property; an assumption of (or taking subject to) a mortgage, trust deed, or contract by the buyer; or the agreement to pay other debt of the exchanger that is not replaced on the replacement property.

Practice Tip: To avoid boot, ensure that the exchanger: (1) Does not actually or constructively receive any of the exchange proceeds; (2) Acquires replacement property of equal or greater net sales price than the relinquished property; (3) Uses all the proceeds from the relinquished property in acquiring the replacement property; (4) Receives only like-kind replacement property; and (5) Obtains debt on the replacement property equal or greater than that paid off, assumed, or taken subject to on the relinquished property.

Qualified Intermediary (sometimes called an accommodator): An independent party to the exchange (not an agent of the exchanger) who facilitates the exchange by receiving and holding the exchange proceeds and using the exchange proceeds to purchase the replacement property for the exchanger. Even if the exchanger does not have possession of the exchange proceeds but has control of the proceeds, this will constitute constructive receipt by the exchanger and the gain will be recognized. The exchanger's real estate agent or broker, banker, employee, attorney, accountant, and related parties are all disqualified to serve as the qualified intermediary. Many companies provide services as qualified intermediaries. Most title insurance companies have affiliated exchange companies, allowing easy coordination of closings and exchanges.

The qualified intermediary becomes the principal in the exchange transaction. The exchanger assigns to the qualified intermediary its interest as the seller of the relinquished property and as the buyer of the replacement property. Generally, the exchanger first enters into a purchase and sale agreement (PSA) for the relinquished property and then, before closing (preferably as soon as possible after entering into the PSA), enters into an exchange agreement with the qualified intermediary and uses an assignment agreement to assign all of the exchanger's interest in the PSA to the qualified intermediary. The qualified intermediary usually provides exchange closing instructions. The forms of exchange agreements, assignment agreements, and exchange closing instructions developed by reputable, experienced, qualified intermediaries are generally good, but the attorney for the exchanger cannot avoid the responsibility to his or her client by complete reliance on these forms.

Practice Tip: To qualify as a 1031 exchange, the exchanger must assign its interest in the PSA to the qualified intermediary. When representing a client in a purchase or sale of real property, unless you have confirmed that your client definitely does not want to engage in a 1031 exchange, include a provision in the PSA that requires the other party to cooperate in a 1031 exchange and execute all documents necessary to effect such exchange.

Identification Period: The period for identifying the replacement property. This period starts on the day the exchanger transfers the relinquished property (generally the closing date) and ends at midnight on the 45th day thereafter. Special rules dictate the number of potential replacement properties that may be identified, the percentage of value for certain identified multiple properties, the type of description required, and to whom the notice must be given. Generally, the identification notice is given to the qualified intermediary, but it may be given to any party obligated to transfer the replacement property to the exchanger. The exchanger should sign and deliver the identification notice by hand, mail, fax, or otherwise send it by midnight on the 45th day. After

the 45th day, the exchanger may not change the list of identified properties. Unless one or more of the listed properties are acquired as replacement properties, the exchange fails.

Exchange Period: The period within which the exchanger must acquire the replacement property. This period starts on the day the exchanger transfers the relinquished property (i.e., the same day that the identification period starts) and ends on the earlier of the 180th day thereafter or the due date (including extensions) of the exchanger's tax return for the year of the transfer of the relinquished property.

Practice Tip: The 45-day identification period and the 180-day (or earlier) exchange period cannot be extended. The customary manner of counting time periods by excluding the first day and including the last day does not apply; both the first day and the last day are included, and it makes no difference if the last day falls on a Saturday, Sunday, or legal holiday.

VESTING OF OWNERSHIP

Title to the replacement property must be held in the same manner as title to the relinquished property, for example, by one spouse or both spouses or by the same entity. (There are exceptions for revocable living trusts and single-member limited liability companies that are disregarded for federal tax purposes.) Generally, the exchanger should not make any changes in the vesting of title to the relinquished or replacement properties before or during the exchange.

The tenancy-in-common interest as replacement property is a relatively new product being offered by the real estate industry. An exchanger may acquire replacement property that is a tenancy-in-common ownership interest in real property, provided that: (a) the real property satisfies the like-kind requirement, and (b) the interest acquired meets the requirements of a legitimate tenancy-in-common and is not subject to being taxed as a partnership. The Internal Revenue Service has issued guidelines to assist exchangers in determining whether a particular tenancy-in-common ownership qualifies as replacement property in a 1031 exchange. The exchanger should satisfy itself, through its own legal and tax counsel, that the tenancy-in-common interest qualifies as exchange replacement property. Tenants in common may exchange or not exchange their interests in a property held in a tenancy in common without affecting the eligibility of the other tenants in common for an exchange.

THE EXCHANGE PROCESS

The typical delayed exchange commences when the exchanger's relinquished property is sold and closed and is completed when the last replacement property is purchased and closed, all of which must occur within the 180-day (or earlier) exchange period. The exchanger assigns its rights in the PSA for the relinquished property to the qualified intermediary. When the exchanger decides on the replacement property, the exchanger also assigns its rights in the PSA for the replacement property to the qualified intermediary. Through these assignments, the qualified intermediary becomes the "seller" of the relinquished property and the "buyer" of the replacement property. When the relinquished property closes, the qualified intermediary holds the exchange funds pursuant to the exchange agreement until the funds are needed for the purchase of the replacement property.

Even though the qualified intermediary acts as the "seller" of the relinquished property, it need not convey the relinquished property, and even though the qualified intermediary acts as the "buyer" of the replacement property, the replacement property need not be conveyed to the qualified intermediary. The Internal Revenue Service allows for "direct deeding" of the relinquished property from the exchanger to the buyer and of the replacement property from the seller to the exchanger. Therefore, the qualified intermediary need not hold title to either the replacement property or the relinquished property, and may thereby avoid potential liabilities of holding title to either property. This direct deeding is generally covered in the exchange agreement and in the exchange closing instructions. The exchange closing instructions usually provide that the closing statement for the relinquished property should show the qualified intermediary as the seller and that the statement of consideration in the deed should state that the consideration is being paid to a qualified intermediary as part of a 1031 exchange.

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