

TAX DEFERRED EXCHANGES

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Tax deferred exchanges, as defined in Section 1031 of the Internal Revenue Code, offers real estate investors one of the best tax strategies for deferring capital gain tax that would ordinarily be assessed on the sale of investment property. A Section 1031 tax deferred exchange permits investors to defer the capital gain on the sale of property that is used in a business or investment provided that the proceeds of the sale are used to purchase "like kind" property for business or investment use.

A. The "Like-Kind" Requirement

To qualify for Section 1031 tax-deferred treatment, property that is sold (the "Relinquished Property") must be exchanged for "Replacement Property" that is of "like-kind". "Like-kind" means that properties must be of the same type or character. "Like-kind" does not take into account differences in grade or quality. Generally speaking, all real estate located in the United States or its possessions is like-kind to other real estate located in the United States or its possessions. The properties are not required to be income producing, but must be "held for productive use in trade or business" or for "investment". If these requirements are met, properties exchanged may be a combination of retail, office, residential rental, commercial, industrial, certain leasehold interests, or raw land.

B. The "Simultaneous Exchange"

In a "Simultaneous Exchange" the old ("Relinquished") real property and the new ("Replacement") real property are transferred concurrently. A Transferor often uses a qualified intermediary to effectuate the transfer of the real property. The use of a qualified intermediary insulates the Transferor from constructive receipt issues and the risk of losing the tax deferred status of the transaction.

C. The "Delayed Exchange"

The most commonly used exchange format is the "Delayed Exchange". A "Delayed Exchange" permits the Transferor up to 180 days to purchase replacement property after the transfer of the Relinquished Property. The "Delayed Exchange" is a three-step process:

- (1) Sale of Relinquished Property.
- (2) Identification of Replacement Property within 45 days of Sale of Relinquished Property.
- (3) Purchase Replacement Property within 180 days of Sale after Relinquished Property.

D. The "Reverse Exchange"

A "Reverse Exchange" occurs when the Replacement Property is acquired before the disposition of the Relinquished Property. Most "Reverse Exchanges" are facilitated through a qualified intermediary who acquires the Replacement Property and holds title until a buyer is found for the Relinquished Property. When the Relinquished Property is ready to be transferred, the qualified intermediary enters into a "Simultaneous Exchange" with the Transferor, transferring ownership of the Replacement Property to the Transferor and acquiring ownership of the Relinquished Property, which the qualified intermediary then sells to the third party buyer.

Investors have been using these techniques for years, but the Internal Revenue Service finally acknowledged reverse exchanges with Revenue Procedure 2000-37, effective September 15, 2000. Three of the most important restrictions imposed by the 2003 Revenue Procedure are:

- (1) The Transferor must enter into a written reverse exchange agreement within five business days after acquisition of the Replacement Property.
- (2) The Transferor has 45 days to identify, in writing, the Relinquished Property.
- (3) The entire Reverse Exchange transaction must be completed within 180 days from the date of the purchase of the Replacement Property to the date of the sale of the Relinquished Property.

E. Important Guidelines in all Tax Deferred Exchanges

- (1) Use all proceeds from the sale of the Relinquished Property
- (2) The transferor must receive only "like-kind" property.
- (3) The fair market value of the Replacement Property must be equal to or greater than the fair market value of the Relinquished Property.
- (4) The debt undertaken to acquire the Replacement Property must, in general, equal or exceed the debt paid from the sale of the Relinquished Property.
- (5) The Transferor should always obtain the advice of their tax counsel before proceeding with any exchange.

For further information, please contact David A. Applebaum or Peter S. Friedman.

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