Smooth Moves - Successful Exchanges Follow These 12 Rules of the Road.
by Ronald L. Raitz, CCIM, and Bridgette M. Raitz, CPA

Despite the best intentions and careful tax planning, common errors often can cause bumps in the road or completely detour tax-deferred exchanges. Misconceptions and inexperience often collide with an increasing number of complex situations. Unfortunately, the exchange crashes, or the optimum tax deferral is not achieved.

However, knowing a few rules of the road can help commercial real estate professionals and their clients avoid a dozen common potholes that can diminish the potential benefits of — or even invalidate — Internal Revenue Code Section 1031 exchanges.

1. Know Replacement Deadlines. An exchanger must acquire a replacement property within 180 days of the relinquished sale or before the next tax filing deadline — whichever comes first.

Although the 45-day identification period is clearly stated, the time frame that an exchanger has to acquire the replacement property ends either 180 days after the sale of the relinquished property or on the date that the tax return must be filed for the year in which the relinquished property was sold. The earlier of these dates is the acquisition deadline.

For example, an exchanger who closes the sale of her relinquished property on Dec. 15, 2000, must complete her exchange in 121 days, by April 15, 2001, because her tax reporting date comes before the end of 180 days. However, filing an extension typically lengthens the acquisition period to allow a full 180 days to close on the replacement property.

An exchanger can commit a fatal error by filing a return before the due date — and before the replacement property is acquired. Consider another exchanger who sells his relinquished property on Dec. 31, 2000. He also has until April 15, 2001, to acquire the replacement property unless he files for an extension. With a closing planned for April 1, 2001, he easily would meet the acquisition deadline. But, the fatal error occurs when his accountant forwards his completed tax return in early March and he immediately mails it to the Internal Revenue Service. Because he has yet to acquire his replacement property, he unwittingly invalidates his exchange because his filing precedes his replacement property closing.

2. Reinvest Cash Proceeds and Replace Debt. To achieve total tax deferral, all cash proceeds from the sale of the relinquished property must be reinvested in the replacement property and any debt relieved must be replaced or netted with new cash. Many exchangers focus solely on the first portion of the formula, but they need to remember that's only half the equation. When acquiring the replacement property, liabilities must be created or assumed that equal or exceed the liabilities from which the exchanger was relieved. If not, the difference will be taxed.

Any new cash — from a source other than the exchange proceeds — that the exchanger uses to purchase the replacement property also will offset any debt received.

A common error occurs when exchangers do not replace the debt, and consequently, fail to maximize their tax deferral.

3. Separate Non-Exchange Expenses. By following normal settlement statement procedures, exchangers sometimes incorrectly use proceeds to pay for certain non-exchange expenses. These items need to be handled separately.

Most commonly, these include prorated rents, security deposits, and certain escrows. By using relinquished proceeds to fund these items, the cash to be re-invested in the replacement property is decreased. Any reduction to proceeds from a non-exchange item is problematic and may trigger tax.

To maximize exchange benefits, these items should be handled on a separate part of the settlement statement or addressed outside of the closing. These items can be shown in the footnote section of the settlement statement or in an exhibit that is attached. Also, the exchanger typically writes a separate check to the buyer for the net amount.

4. Waive Non-Resident Withholding. Withholding for an out-of-state or non-U.S. seller often leads to cash boot that is taxable. Many states require that the closing agent withhold a certain percentage of the sales price if one of the parties in the transaction is an out-of-state or non-resident alien (someone filing a tax return in a state other than where the relinquished property is located). States may find it difficult to track down people who live out of state and may not file a state tax return, and they want to ensure that they receive any revenue due.

Foreign Investment in Real Property Tax Act of 1980 regulations require that 10 percent of the purchase price be withheld. To obtain a refund for the amount withheld, the exchanger must file a return in the state containing the relinquished property at the end of the tax year. Further, a federal return must be filed to obtain a refund of the amount withheld under the FIRPTA regulations.

This withholding requirement complicates an exchange transaction. If the exchanger is forced to withhold taxes that would be due on a normal sale, then a portion of the exchange proceeds must be sent to the state. This withholding will not be refunded until the following year when the exchanger files for a refund. When the refund is received, it will be considered cash boot to the exchanger and be taxable.

The federal government and many states waive the withholding if certain procedures are followed or forms are submitted. Contact a particular state's department of taxation for more information. This can eliminate any withholding that later will trigger cash boot.

5. Fund Escrows Out-of-Pocket. Escrowed relinquished proceeds eligible for release when performance hurdles are met can trigger tax if the release occurs after the replacement property closes.

It is not uncommon for a purchaser to require a seller to escrow a stipulated amount of the purchase price that later can be released once a certain action is completed or a benchmark reached. Examples include certain leasing or occupancy targets and satisfactory resolution of easement issues. Contractually, the closing attorney escrows these amounts.

In an exchange scenario, problems arise when the escrowed proceeds are not released until after the replacement property is acquired. When this occurs, the additional proceeds forwarded cannot be used in the acquisition. The cash balance is disbursed to the exchanger and triggers taxable gain.

Although the exchanger may be relatively certain that escrows will be released before the replacement property closing, an element of risk exists. Consequently, if the exchanger has the financial wherewithal, it often is best to fund any escrows required in the transaction out-of-pocket. This allows all proceeds from the sale of the relinquished property to be forwarded to the qualified intermediary for reinvestment in the replacement property.

6. Use an Appropriate Intermediary. The closing attorney or title company does not become an ad hoc intermediary just by holding the proceeds. An exchange is more than a rollover election in which a property is sold and a replacement property purchased within a certain time frame. In a delayed exchange, even if the closing agent holds the proceeds, the exchange requirement will not be met unless there is compliance with other exchange rules as well.

In a delayed exchange, the exchanger must use a qualified intermediary who is responsible for coordinating the required paperwork under Section 1.1031(k)(1)(g)(4)(v). Through the use of a carefully crafted exchange agreement and other stipulated documents, the qualified intermediary must meet the safe-harbor standards for a successful exchange.

Further, anyone who is considered an agent of the exchanger at the beginning of the exchange transaction is considered a disqualified party and prohibited from acting as the qualified intermediary.

Consequently, a closing agent who is the exchanger's personal attorney or has provided the exchanger legal services in the past two years is disqualified. This is not true of anyone who performs routine financial, title insurance, escrow, or trust services through a financial institution, title insurance company, or escrow company.

7. Reimburse Earnest Money. The method in which earnest money is documented and disbursed may require changes to both the relinquished and replacement property settlement statements.

If an exchanger holds earnest money pending the sale of the relinquished property, she must reimburse it at or before the closing (to avoid the amount inadvertently becoming cash boot). This can be done by making the earnest money refund payable to the closing attorney or by refunding the earnest money to the purchaser at the closing. If the exchanger still possesses the earnest money after closing, she is considered to be in receipt of exchange proceeds and gain will be recognized on that amount.

At the replacement property closing, this situation arises only if the exchanger anticipates that there will be exchange proceeds remaining once all replacement property is acquired and the earnest money is advanced from the exchanger's own funds.

If the exchanger is buying a replacement property that requires more cash to close than the amount held by the qualified intermediary, he will have to forward additional cash to the closing. In this case, there is no need to reimburse the earnest money. If excess proceeds are available, he may want to be reimbursed for any earnest money he advanced. In this instance, the closing attorney may reimburse the earnest money to the exchanger.

This action will create a need for additional funds from the qualified intermediary, effectively using more of the remaining proceeds. The qualified intermediary should avoid reimbursing earnest money to the exchanger directly.

8. Related Parties Follow Different Exchange Rules. Buying replacement property from a related party can invalidate an exchange.

Under the rules, the exchanger can sell relinquished property to a related party, no problem. If related parties do a direct swap neither party can sell the property for at least 24 months. If the related party disposes of the property before then, the gain from the original sale is triggered. However, because of concerns about abuse of related-party basis shifting, the exchanger can only buy replacement property from a related party if the related party is also doing an exchange or if the related party is paying more tax than what is being deferred by the taxpayer.

9. Second Homes Don't Qualify. For real estate to qualify for exchange treatment, the property must be considered real property and meet the qualified-use test. Although second homes, by their nature, are considered real property, they often fail to meet the qualified-use test. To be eligible, the property must be held for investment.

If you do not rent it out, it does not qualify. If you use it for more than 2 weeks a year it probably won't qualify. The IRS has specifically outlined in Revenue Procedure 2008-16 the 1031 rules for vacation homes.

10. Title Should Be Received in the Same Way It Was Given. Occasionally, an entity issue arises when an exchanger needs or wants to take title to the replacement property in a different manner than how it was conveyed on the relinquished property. Although Section 1031 does not state that title must be received on the replacement property in the same way as it was given on the relinquished property, it is directly implied. An exchange must start with the same tax identification number and end with the same tax ID number. Subsequent case law has reinforced this understanding.

For an exchange to be valid, the seller of record on the relinquished property must be the same as the purchaser of record on the replacement property, unless a tax-transparent entity, such as a single-member LLC, is substituted.

For instance, if Joe and Mary Smith sell the relinquished property and only Mary purchases the replacement property, an entity issue would arise.

For the best chance of completing a successful tax-deferred exchange, it is important to outline the entire transaction being contemplated and highlight any entity problems in advance. Once potential problems are identified, they often can be neutralized effectively in the planning stages. It is much more difficult to address entity issues successfully once the transaction begins.

11. Personal Property Is Not Like-Kind With Real Property. Failing to replace incidental personal property involved in a sale triggers tax on any gain. Incidental personal property most often appears in real estate exchange transactions that have a small component of personal property.

For example, the sale of an apartment complex may include commercial washers, dryers, and vending machines. For identification purposes, if this incidental property represents 15 percent or less of the value assigned to the larger asset — the real estate — then the incidental property does not have to be separately identified. A problem often arises because personal property cannot be exchanged for real property.

However, if this incidental personal property is assigned a value that exceeds the current tax-basis book value and is not replaced with other like-kind personal property, it can trigger a gain.

Although there is not a separate identification requirement for incidental personal property, it is not considered like-kind with the real property. Consequently, if the value associated with the personal property is used to acquire real property, gain will be triggered.

12. Handle Refinancing Separately. Refinancing in anticipation of an exchange can trigger gain; an independent business objective should be the primary motivation for refinancing.

One of the core exchange principles is that the exchanger not receive any cash. Some issues may arise if an exchanger receives cash from refinancing the relinquished property in anticipation of the exchange. Without an independent business reason, this potentially can trigger a taxable consequence.

This seems to be less of an issue if the replacement property is refinanced after an exchange. Differing views exist on whether an exchanger should be able to refinance immediately or should wait for a certain

time period. Most professionals recommend that the refinancing be distinctly separate from the exchange process, serve an independent economic purpose, and be done after some time has lapsed.

Think Ahead As always, commercial real estate professionals should review exchange issues with a tax professional. Many of these issues do not come to the attention of the client's tax counsel until tax returns are being prepared. Unfortunately, by then it usually is too late.

Knowing what questions to ask can help flag potential issues in advance. Understanding the right questions to ask can make all the difference in helping clients get the most benefit from a 1031 exchange.