Topic: Commercial Purchase and Sales

Subtopic: Closing and Other Ancillary Documents

1. 1031 Exchanges

2. Introduction to Real Property 1031 Exchanges

S. H. Spencer Compton is vice president and special counsel in the New York City office of First American Title Insurance Company.

The author would like to acknowledge the generous assistance of his colleagues at First American Exchange Company: Mark Bullock and Ray Novinc.

Section 1031 of the Internal Revenue Code provides that no gain or loss will be recognized when property held for productive use in trade or business, or for investment, is exchanged for like-kind property which will also be held for productive use in trade or business, or for investment. Most states (Pennsylvania being a notable exception) allow such an Exchangor (as defined below) to defer state capital gains tax as well. Put simply, in a 1031 exchange transaction, the seller of qualified property can use the entire equity in the property to purchase Replacement Property (as defined below). Federal and state capital gains taxes are deferred.

Many real estate advisors regard the 1031 exchange mechanism as one of the few "free lunches" available to ordinary real estate investors. Real estate practitioners should be familiar with 1031 exchange transactions to effectively represent sellers of properties held for business use or for investment. Too many potential 1031 exchange transactions go unrealized, with capital gains taxes paid, due to real estate investors' lack of information or misapprehensions about the wealth-building benefits of exchange transactions. Real estate and tax advisors owe it to their clients to advise them fully of the advantages of a 1031 exchange. When advising a client regarding the viability of a 1031 tax-free exchange, real estate attorneys should always work in concert with the client's tax adviser.

3. What is a 1031 Exchange?

Section 1031 of the Internal Revenue Code and the deferred exchange regulations allow a seller of real estate to defer the federal gain on the sale of real property held for business use or for an investment if:

(i) the property is used in a trade or business or held for investment,

(ii) the property is exchanged for like-kind property, and

(iii) certain time frames for identification and acquisition of the replacement property are met.

An Exchangor can defer taxes by selling a Relinquished Property (as defined below) and acquiring Replacement Property at a later date, and provided that all of the rules are followed, the transaction will be considered an exchange rather than a sale followed by a purchase. For this to happen, the Exchangor cannot have actual or constructive receipt of the Exchange Funds (as defined below). In this regard, the Exchangor need not actually take possession of the Exchange Funds after the Relinquished Property

closes to create a problem. If any of the Exchangor's agents (such as his or her attorney) takes possession of the Exchange Funds, or if the Exchangor has the right to direct the disposition of the Exchange Funds, the Exchangor can be considered to have constructive receipt of the funds, and the exchange could be compromised.

An Exchangor must have an identifiable interest in both the Relinquished Property and the Replacement Property to have a successful exchange. Acquisition of a 100% interest in an entity whose sole asset is the Relinquished (or Replacement) Property will qualify, but lesser percentages of membership interests, partnership interests or shares of stock in entities that own the real property will not. In a standard deferred exchange, the deed for the Relinquished Property will be from the Exchangor to the buyer, and the deed for the Replacement Property will be from the seller to the Exchangor. During a standard deferred exchange, the QI (as defined below) will never be in title to either property.

To fully defer all taxes, an Exchangor must accomplish two things:

(i) reinvest all Net Proceeds (as defined below) realized from the sale of the Relinquished Property into the Replacement Property(ies), and

(ii) reacquire debt equal or greater to the debt paid off from the Relinquished Property (or replace with fresh cash).

It should be noted that where an Exchangor invests some, but not all, of the Exchange Funds into the Replacement Property(ies), capital gains tax will be owed on the balance not invested (Boot).

A 1031 exchange begins on the earlier of:

(i) the date of deed recordation, or(ii) the date possession of the property is transferred to the buyer,

and ends on the earlier of:

(i) 180 days after the 1031 exchange begins, or (ii) the due date of the Exchangor's tax return, including extensions, for the taxable year in which the Relinquished Property is transferred. By using some or all of the profit from the sale of one property to invest in another, an investor can continue to defer capital gains on successive transactions while building their equity and rental income stream.

3. Section 1031 of the Internal Revenue Code, its History and Intent

What is the rationale for the 1031 exchange? Where a seller of investment property reinvests its Net Proceeds and retired debt into a like-kind Replacement Property, the seller's economic position has not changed. It has not received an economic gain or cash with which to pay capital gains taxes triggered by the sale. Accordingly, to require the taxpayer to pay such taxes would be unfair. The tax obligation is not eliminated, rather it is deferred until the Replacement Property is sold. If the Replacement Property is sold and another 1031 exchange is not initiated, the original deferred gain plus any additional gain realized since the Replacement Property purchase is taxed.

The 1031 exchange became law with the Revenue Act of 1921 and remained largely unchanged from 1928 to 1984, when time limits were imposed as a result of the Starker decision 602 F2d 1341 (9th Cir.. 1979). Prior to 1979, 1031 exchanges were accommodated in one day long closing where the Relinquished Property was closed, followed by the Replacement Property closing. The impact of the Starker decision was that 1031 exchanges did not have to close the same day; the closings could be delayed. What is now known as a forward or standard deferred exchange allows for the Relinquished Property to be closed on one day followed on another day by the Replacement Property closing. A deferred exchange allows the taxpayer to relinquish property currently and receive like-kind Replacement Property in the future. But in 1984, Congress decided to limit the scope of the Starker decision by enacting Sec. 1031(a)(3), a provision which permits deferred exchanges to occur within a specific time frame. In 1984, the 45 and 180 calendar day limits were imposed, requiring the potential Replacement Property to be identified by the 45th calendar day post-closing with the 1031 exchange completed no later the 180th calendar day post-closing.

3. Glossary of Terms

The terms below are commonly used in 1031 exchange transactions.

- *ACCOMMODATOR or Qualified Intermediary ("QI")*: In 1991, four safe harbors were created as a bright-line test to determine whether the taxpayer is in actual or constructive receipt of funds or property while having initiated an exchange. One of these safe harbors is the use of a Qualified Intermediary to hold the Exchange Funds during the exchange period. The (g)(6) limitations of the 1031 code state that "in no event shall Exchangor receive, pledge, borrow, or otherwise obtain the benefits of the Exchange Account, including earnings, thereon, before the Exchange Period." Once a taxpayer touches the exchange funds or receives a note payable from the property buyer, it is considered boot and taxable. Use of safe harbors prevents the taxpayer from having access to the exchange funds.

- *ADJUSTED BASIS:* The cost of the property adjusted for any capital improvements or depreciation. Original cost of property + Improvements - depreciation = Adjusted Basis.

- *BASIS:* The starting point for determining gain or loss in any transaction. In general, basis is the cost of the taxpayer's property. Note that transactions involving exchanges, gifts, probates, and receiving property from a trust can have an impact on calculating the property's adjusted basis.

- *BOOT:* Boot is an old English term meaning "Something given in addition to." Cash or non-cash consideration, including any property that is not "like-kind," promissory notes, debt relief (mortgage boot) or other property. "Other Property" is property that is non-like-kind, such as personal property, a promissory note from the buyer, a promise to perform work on the property, a business, etc. There are many ways an Exchangor can receive "Boot", even inadvertently. The Exchangor should consult with its tax advisor to understand what can result in Boot. If Boot is received in an exchange, it is likely that all or some portion of the Boot will be taxed.

- *BUILD-TO-SUIT EXCHANGE (Also known as Construction Exchange or an Improvement Exchange):* The build-to-suit exchange allows an owner to use the proceeds from the sale of the

relinquished property not only to acquire Replacement Property, but also to make improvements to the property. A build-to-suit exchange is accomplished by having a holding entity (called an "exchange accommodation titleholder" or "EAT") temporarily hold title to the Replacement Property while the improvements are being made.

- *BUYER:* The person acquiring the Exchangor's Relinquished Property.

- *EXCHANGE ACCOMMODATION TITLEHOLDER (or EAT):* A new single purpose entity, usually an LLC, formed by the QI to take title to the Replacement Property prior to the sale of the Relinquished Property (or vice versa).

- *EXCHANGE FUNDS:* The Net Proceeds from the sale of the Relinquished Property

- *EXCHANGOR:* The taxpayer seller/purchaser of like kind investment real property.

- *CLOSING COSTS:* Miscellaneous expenses involved in closing a real estate transaction over and above the price of the land.

- *I.R.C.:* Internal Revenue Code

- *INVESTMENT PROPERTY:* Property located in the USA that is held for productive use in a trade or business or for investment. Under IRC 1031, property used as a personal residence or property held for resale is not investment property.

- *NET PROCEEDS:* The proceeds of the sale of the Relinquished Property less allowable expenses (transfer taxes, brokerage commission etc.) in accordance with IRC Section 1031.

- *QUALIFIED INTERMEDIARY* or *QI:* See ACCOMODATOR above.

- *RELINQUISHED PROPERTY:* The investment property being sold as the first step of a 1031 exchange transaction.

- *REPLACEMENT PROPERTY:* The investment property being purchased to replace the relinquished property.

3. How a Forward 1031 Exchange Works

Susan bought an investment property for $300,000 several years ago and put an additional $100,000 into capital improvements. Her basis is now $400,000. Susan enters into a contract of sale for $600,000. Her capital gain would be $200,000 which, assuming a capital gains tax rate of 23.8 %, would mean a $47,600 tax bill. To defer paying this tax, Susan engages a Qualified Intermediary to assist in structuring her sale as the first leg of a 1031 exchange. If Susan wants to defer all gains from the sale of the Relinquished Property, at closing, all of Susan's Net Proceeds are paid by the buyer or closing agent directly to the QI. The funds are deposited into a segregated interest-bearing escrow account controlled solely by the QI. Within 45 days after the date of closing of the sale of the Relinquished Property, Susan

identifies in a writing sent to the QI up to three potential Replacement Properties. If Susan wants to identify more than three properties a rule (the "200%" Rule) applies for the identification. In such event, the total value of all identified properties cannot exceed 200% of the value of the Relinquished Property (See "Identification Rules" below). Within 180 days of the sale of the Relinquished Property, Susan directs the QI to fund her purchase of one of the Replacement Properties. If there are any remaining funds held by the QI, they are paid over to Susan together with interest earned. Such non-reinvested funds (which are Boot) are subject to capital gains tax.

3. Purchase and Sale Contract Language

In the event that a property will or may be the subject of a 1031 exchange, it is advisable to include the following language, as specified, in each of the contract to sell (Phase 1) and the contract to purchase (Phase 2).

- *BUYER OF EXCHANGOR'S PROPERTY - COOPERATING WITH EXCHANGOR (Sale of Relinquished Property – Phase I):*

  "Seller reserves the right to include this transaction via an assignment of Seller's rights as part of an IRC, Section 1031 tax deferred exchange for the benefit of Seller, at no cost, expense or liability to Buyer. Buyer further agrees to execute any and all documents (subject to the reasonable approval of Buyer's counsel) as are reasonably necessary in connection therewith, provided that the close of this transaction for the conveyance of Seller's property shall not be contingent upon or subject to the completion of such exchange. Buyer understands and acknowledges that Seller is participating in the [_______________ Tax Deferred Exchange Program]. Seller agrees to indemnify and hold Buyer free and harmless from any cost, expense or liability, including attorney's fees resulting from Buyer's participation in such exchange."

- *SELLER OF ACQUISITION PROPERTY - COOPERATING WITH EXCHANGOR (Purchase of Replacement Property – Phase 2):*

  "Buyer reserves the right to include this transaction via an assignment of buyer's rights, as part of an IRC, Section 1031 tax deferred exchange for the benefit of Buyer, at no cost, expense or liability to Seller. Seller further agrees to execute any and all documents (subject to the reasonable approval of Seller's counsel) as are reasonably necessary in connection therewith, provided that the close of escrow for the conveyance of Seller's property shall not be contingent upon or subject to the completion of such an exchange. Buyer agrees to indemnify and hold Seller free and harmless from any cost, expense or liability, including attorney fees, resulting from Seller's participation in such exchange."

3. Time Periods

The Exchangor has 45 days from the closing of the Relinquished Property to identify Replacement Property. Proper identification of Replacement Property is a requirement for a valid exchange, and the Exchangor can only acquire property which has been properly identified during the 45-day identification period. Replacement Property that is acquired (i.e., closes) within the 45-day time period is considered properly identified. For property not purchased within the 45-day time frame, the identification must

unambiguously describe the property (with an address or legal description), and must be made in writing, signed by the Exchangor and sent before midnight of the 45th day. If multiple Relinquished Properties are grouped together in one exchange, the 45-day time period starts to run as of the closing of the first property.

3. Qualified Intermediary: Who Should Act as One?

For any size exchange, a Qualified Intermediary will ideally be a subsidiary of a high net worth, long standing financial institution, such as a bank or a title insurance company. Although there are many smaller companies, and even individuals, who act as Qualified Intermediaries, the Exchangor will be best protected by a deep-pocketed entity willing and able to provide an indemnity against any employee malfeasance. The greater the volume of exchanges the QI processes, the lower the fees it is able to charge. Certain persons may not act as the QI. Generally, these include certain relatives of the Exchangor, or someone who, within a two-year period prior to the exchange, has acted as the Exchangor's agent, such as her attorney, accountant, or real estate broker.

3. Identification Rules

If an Exchangor wants to identify more than one Replacement Property, there are several options. The three most common methods to identify multiple properties are:

(i) *The "Three Property" Rule*: the investor may identify up to three properties without regard to their fair market value; or

(ii) *The "200%" Rule:* the Taxpayer may identify any number of properties so long as the total fair market value of all of the listed properties does not exceed 200% of the value of the Relinquished Property; or

(iii) *The "95%" Rule*: If both above rules are exceeded in the number and value of the properties identified, it will be considered valid if at the end of the exchange, the Exchangor has succeeded in acquiring properties worth an aggregate of at least 95% of the fair market value of all of the properties originally identified For example, you may identify $1,000,000 in Replacement Property and acquire only $950,000 in Replacement Property.

3. "Like Kind" Rules

The Replacement Property must be considered "like-kind" to the Relinquished Property. The like-kind requirement is broad for real property exchanges. For example, an office building can be exchanged for vacant land, an apartment building can be exchanged for a single family rental home, or a duplex can be exchanged for a retail strip center. Generally, "like kind" in terms of real estate, means any property held for productive use in a trade or business or for investment that is classified real estate in any of the 50 US states, and in some cases, the US Virgin Islands. A real property within the United States and a real property outside the United States would not be like-kind properties. Multiple properties qualify. For example, a single property may be exchanged for several properties and vice versa.

3. Transaction Process: Document Forms

The QI will provide the documents necessary to consummate the 1031 exchange transaction. Except on occasion in the case of a very large and/or complex transaction, the QI's forms are not negotiated. The main provisions of the two principal documents in a 1031 exchange transaction are summarized below:

- **The Exchange Agreement** (executed by the QI and the Exchangor) provides that the Exchangor will transfer the Relinquished Property to the QI in exchange for the receipt of like kind Replacement Property from the QI. The QI agrees to acquire the Relinquished Property from the Exchangor, transfer the Relinquished Property to the buyer, acquire the Replacement Property from the seller and transfer the Replacement Property to the Exchangor with the intent that the procedures in the Agreement qualify as an exchange under I.R.C. § 1031. Note that the QI does not actually take title to either the Relinquished Property or the Replacement Property in a direct or standard deferred exchange. The Exchange Agreement provides for direct deeding from the Exchangor to the buyer and from the seller to the Exchangor as well as for the possession by the QI of the Exchangor's net proceeds during the time between the closing of the sale of the Relinquished Property and the closing of the purchase of the Replacement Property.

- **The Assignment Agreement** (executed by the QI and the Exchangor, with the buyer signing an acknowledgment of receipt of a copy) in which the Exchangor assigns the Exchangor's rights, but not its obligations, in the relinquished property agreement (e.g. the purchase agreement between the Exchangor, as seller, and the buyer) to the QI. The QI accepts the assignment of the Exchangor's rights as seller in the Relinquished Property Agreement, subject to the terms and conditions of the Assignment Agreement and the Exchange Agreement. The QI directs the Exchangor to execute and deliver the deed, and any other conveyance and transfer documents, for the Relinquished Property directly to the buyer. The Exchangor releases the QI from all liability in connection with its participation in the relinquished property agreement, except liability arising from the QI's own willful misconduct or gross negligence. Where the Exchangor will retain some of the net proceeds (and pay proportionate capital gains tax) the Assignment provides that it does not include a specified dollar amount of net proceeds from the sale of the Relinquished Property, which shall be retained by the Exchangor.

Note that the QI will not warrant the tax consequences of the transaction and will require a representation from the Exchangor that it has consulted and solely relied upon the advice of its own independent legal counsel as well as its tax advisor.

- With respect to the second leg of the 1031 exchange (sometimes referred to as Phase 2) where the QI purchases the Replacement Property using the Exchange Proceeds it has been holding, there is only one operative

document: **The Assignment Agreement (Replacement Property)** (executed by the QI and the Exchangor). Here, the Exchangor assigns the Exchangor's rights, but not its obligations, in the replacement property agreement to the QI and the QI accepts the assignment of the Exchangor's rights as Buyer in the Replacement Property Agreement, subject to the terms and conditions of the Assignment and the Exchange Agreement. Additionally, the QI instructs the Exchangor to receive the deed, and any other conveyance and transfer documents, for the Replacement Property directly from the Seller.

The Exchangor releases the QI from all liability in connection with its participation in the replacement property agreement, except liability arising from the QI’s own willful misconduct or gross negligence. The Exchangor acknowledges that the QI has made no representations or warranties concerning the Replacement Property, the physical condition of the Replacement Property, or the condition of legal title thereto. The Seller of the Replacement Property is asked to execute an **Acknowledgement** that it has been notified of the Assignment Agreement and received a copy thereof.

3. Time Extensions

Extensions for an exchange are not granted on a case by case basis. Where the President declares one or more counties to be federal disaster areas, affected taxpayers who reside, have a business in or are involved in a 1031 exchange with respect to properties in these counties may be eligible for up to a 120-day time extension for completion of their exchange under the 180-day rule, and submission of their 45-day letter identifying prospective Replacement Properties.

3. What Happens if a 1031 Exchange Transaction Fails?

Where a 1031 exchange transaction fails for either (i) failure to identify Replacement Property within 45 days or (ii) failure to close within 180 days, the Qualified Intermediary will return the Exchange Proceeds to the Exchangor together with any interest earned, less the Qualified Intermediary’s fee. Note that where the transaction fails after the 45 day identification period has passed, under Section 1031, the Qualified Intermediary may not be able to return the Exchange Proceeds until day 181. The Exchangor will owe capital gains taxes and penalties for late payment if applicable from the date that the Exchangor is entitled to receive proceeds under the Exchange Agreement.

3. Transformation of Personal Use to Investment Use

With Revenue Procedure 2008-16 which applies to vacation homes and second residences, the IRS created a safe harbor for taxpayers wishing to use Section 1031 with properties that follow a simple set of rules:

For at least two years prior to, and after the exchange; and in each of the two twelve month periods in the qualifying period:

- The property must be rented at a fair market rental for a minimum of two weeks to a non-relative.
- The property may be rented to a relative if it is their primary residence at fair market value rent.
- The property must only be used personally for 14 days or 10% of the time rented during the 12 month period.
- Documentation must be kept for these activities.
- The property should be placed on Schedule E of the taxpayer's tax return and reported as income property.

Attorneys should advise clients to confirm their compliance with these rules with their tax advisors.

3. What is a Reverse 1031 Exchange?

A reverse exchange occurs when an Exchangor wants to acquire Replacement Property prior to the closing of the sale of the Relinquished Property. Although common terminology calls this type of transaction a "reverse exchange," the Exchangor does not actually acquire the Replacement Property first and dispose of the Relinquished Property later. Instead, the Exchangor must arrange for an Exchange Accommodation Titleholder (or "EAT"), a special purpose entity (formed by the QI) which is a separate single member limited liability company that will be used *exclusively* for the contemplated reverse 1031 exchange transaction, to take title to either the Relinquished Property ("exchange first transaction") or the Replacement Property ("exchange last transaction"). A reverse exchange must be set up and structured with an EAT prior to the Replacement Property closing.

4. Example Reverse 1031 Exchange Transaction

Perhaps your client has unexpectedly found an investment opportunity that she must act on before she even has time to consider selling or listing her Relinquished Property. Or, she fears the sale of her Relinquished Property may collapse and she does not want to lose her Replacement Property acquisition that is closing soon. The reverse 1031 exchange allows her to acquire the Replacement Property first and then subsequently list and sell the Relinquished Property within the prescribed 1031 Exchange deadlines. The actual 1031 exchange portion of the reverse 1031 exchange transaction will be a simultaneous 1031 exchange either at the beginning or end of her reverse 1031 exchange transaction (depending on whether it is an exchange first or an exchange last structure). In either instance, the EAT will acquire and hold or "park" legal title to either her Relinquished Property or her Replacement Property during the reverse exchange transaction.

There are two different types of reverse 1031 exchanges – the exchange last transaction and the exchange first transaction. The steps for each type of transaction are outlined below.

4. Reverse 1031 Exchange - Exchange Last Transaction

(i) In an exchange last transaction, the EAT acquires title to the Replacement Property at the scheduled closing. The acquisition is funded by the Exchangor and/or a third party lender.

(ii) The EAT leases the Replacement Property to the Exchangor, and the lease provides that the Exchangor receives all of the income and pays all of the expenses of the Replacement Property.

(iii) Once a third party buyer is found for the Relinquished Property, the Relinquished Property is transferred to the buyer and the Relinquished Property proceeds are transferred to the Qualified Intermediary.

(iv) After the Relinquished Property has been transferred to the buyer, the Exchangor acquires the Replacement Property held by the EAT using the Exchange Funds. If there are remaining Exchange Funds, the Exchangor may acquire additional Replacement Properties as part of the forward exchange, provided that they were properly identified.

4. Reverse 1031 Exchange - Exchange First Transaction

(i) In an exchange first transaction, the EAT acquires title to the Relinquished Property prior to the scheduled closing of the Replacement Property.

(ii) The EAT leases the Relinquished Property to the Exchangor, and the lease provides that the Exchangor receives all of the income and pays all of the expenses of the Relinquished Property.

(iii) On the scheduled closing date, the Exchangor takes title to the Replacement Property.

(iv) Once a third party buyer is found for the Relinquished Property, the Relinquished Property is transferred to the buyer and any net sale proceeds from the Relinquished Property are used to retire any debt, or portion thereof, incurred by the EAT on its acquisition of the Relinquished Property.

Reverse exchanges under the IRS safe harbor rules must be completed within 180 days of the date the EAT acquires title to the Relinquished Property. In an exchange last transaction, the Exchangor has 45 days from the first closing to identify the Relinquished Property. The 180 day timeframe begins on the day the EAT takes title to the Replacement Property. Most rules that apply to tax-deferred exchanges also apply to reverse exchanges. Each of these transactions must be set up as an exchange, rather than as a sale followed by a purchase. To qualify for a safe harbor reverse exchange, the Exchangor must comply with Revenue Procedure 2000-37 which provides how to properly structure a Reverse 1031 Exchange transaction by using a parking arrangement in conjunction with a simultaneous 1031 Exchange.

4. Reverse 1031 Exchange Transaction Process: Document Forms

Because a reverse 1031 exchange is more complex than a forward 1031 exchange, the QI will provide a greater number of documents:

- **Qualified Exchange Accommodation Agreement** (executed by the EAT and the Exchangor).
- **Lease** (executed by the EAT as lessor and the Exchangor as lessee) governs the Exchangor's use and occupancy of the Replacement Property during the period of the EAT's ownership.
- **Assignment Agreement** (executed by the EAT and the Exchangor) with an attached **Acknowledgement of Receipt** (executed by the Seller).
- **Promissory Note** (to be executed by EAT).

4. What happens if a Reverse 1031 Exchange Fails?

If the Exchangor cannot find a buyer for the Relinquished Property during the 180 day period, the EAT will transfer the property it is holding to the Exchangor. If this happens, the Exchangor has lost an opportunity to trade in the Replacement Property, and has paid some non-fundable fees for the reverse exchange. As an exit strategy, the Exhangor can eventually do a forward exchange with the Relinquished Property once it is ready to close, if the Exchangor plans to buy more Replacement Property.

3. What is a Construction or Improvement 1031 Exchange?

An improvement exchange occurs when the Exchangor wants to acquire Replacement Property and build improvements on it during the exchange period. This usually occurs when the Exchangor determines that he will have exchange funds in excess of the cost of the Replacement Property. The excess equity is used to construct improvements on the Replacement Property. In an improvement exchange, the EAT holds title to the Replacement Property, but the construction may be managed by the Exchangor. The Exchangor must identify what will be constructed on the Replacement Property within 45 days after the Relinquished Property is transferred to the buyer. The exchange must be completed within 180 days, but the construction does not need to be completed during that time. Nevertheless, the only property that is considered "like-kind" for exchange purposes will be property that is considered to be real property, i.e., attached to the land or building.

4. Example Improvement 1031 Exchange Transaction

The improvement exchange (also known as a build-to-suit exchange) allows an Exchangor to use the proceeds from the sale of its Relinquished Property not only to acquire Replacement Property, but also to make improvements to it. For example, if an Exchangor sells Relinquished Property with a fair market value of $1,000,000, debt of $200,000 and equity of $800,000, he must acquire a property equal to at least $1,000,000 and must invest at least $800,000 into that property. In a build-to-suit or improvement exchange, however, the Exchangor could acquire property worth only $300,000, borrow an additional

$200,000 and spend the remaining $500,000 of exchange proceeds plus the $200,000 in loan funds on improvements to the property. This would use up the remaining cash and increase the fair market value of the Replacement Property to $1,000,000, resulting in a fully tax-deferred exchange.

A build-to-suit exchange is accomplished by having the EAT temporarily hold title to the Replacement Property while the improvements are being made. The EAT is necessary because any work done to the property after the Exchangor takes title to it is not considered like kind property and therefore will not increase the property's value for exchange purposes.

A build-to-suit exchange can be structured either as a deferred exchange where the existing property is sold before the new property is acquired, or a reverse build-to-suit, where the new property is acquired first. In either case, the entire transaction must be completed within 180 days.

4. Deferred Build-to-Suit Exchange

In a deferred build-to-suit exchange, the Relinquished Property is disposed of and the sale proceeds go to the QI. The Exchangor must identify Replacement Property within 45 days, including a description of what will be built on the property. The EAT acquires the property using the exchange funds. The Exchangor oversees the construction of the improvements and periodically sends invoices to the EAT, who pays them using exchange funds. The Replacement Property is transferred from the EAT to the Exchangor upon the first to occur of: construction completion, or when the 180 day exchange period expires or when enough value is added to the Replacement Property for full tax deferral.

4. Reverse Build-to-Suit Exchange

In a reverse build-to-suit exchange, the Replacement Property is acquired by the EAT first, using funds from the Exchangor or a lender. As with a deferred exchange, the Exchangor supervises the construction and sends invoices to the EAT, but the EAT must borrow money from the lender or the Exchangor to pay the invoices. At some point during the 180 day period, the Relinquished Property is sold and funds are transferred to the QI. If there is more construction needed, the exchange funds can be used for the construction until the 180 day period expires. As with the deferred build-to-suit, the Replacement Property is transferred from the EAT to the Exchangor on the first to occur of: when the construction is complete, or when the 180 days expires or when enough value is added to the Replacement Property for full tax-deferral.

3. Personal Property Like-Kind Exchanges

Although this practice note has discussed only real property like-kind exchanges, the I.R.C. also contemplates certain defined personal property exchanges such as rental car portfolios, aircraft, livestock and art works. Where the like-kind rules for real property exchanges are broad, the like-kind rules for personal property exchanges are narrow. For example, a cow may not be exchanged for a bull (only for another cow), a bronze sculpture may not be exchanged for an oil painting (only for another

bronze sculpture) and so forth. Practitioners are encouraged to consult the relevant sections of the I.R.C. for further illumination.

3. 1031 Exchange Q&A.

Below is a list of common questions regarding 1031 exchanges.

1. *Part of my client's property is used as her personal residence, the rest is rented out. Can she still structure her sale as a 1031 Exchange?*

Yes. IRS rulings provide that the designation of exchange property may be apportioned as between investment property and personal residence. She can structure that portion of the value of her sale attributable to investment property as a 1031 Exchange. Be sure she consults her tax advisor.

2. Can my client turn his sale into the first leg of a 1031 exchange by directing the closing agent to hold his sales proceeds in an escrow account until my client later directs him to use the proceeds to purchase a replacement property?

No. The transaction is taxable because the taxpayer has constructively received the sales proceeds and still has control over their disposition. He has the right to change the escrow instructions and to withdraw the monies. Furthermore, in the transaction above, the taxpayer is not transferring property to a person and getting property back from that person in exchange. To withstand IRS scrutiny and qualify as a 1031 exchange, the two transactions must be interrelated and interconnected with each other. There must be an intermediary or buyer/seller cooperation.

3. Does my client have to find a seller of replacement property who wants to buy her relinquished property so the parties can trade them?

No. The majority of 1031 transactions are three parties (e.g. a buyer, a seller and an intermediary) involved in the exchange of two properties. Real estate brokers and consultants serve as matchmakers, bringing buyers and sellers together on demand. Today's 1031 exchange marketplace is a fluid one.

4. Does my client have to sell his relinquished property and buy the replacement property simultaneously?

No. The logistics of coordinating the various parties to a simultaneous transaction would chill (if not kill) most exchange transactions. The exchange must be interdependent but need not occur simultaneously. This is one of the benefits of using an intermediary.

5. Can my client only exchange a buggy whip manufacturing facility for another buggy whip manufacturing facility? Are the 1031 exchange like-kind requirements restrictive and hard to satisfy? No. For real property, the like-kind standard is very broad. All real property is like-kind property to all other real property. Vacant land can be exchanged for developed property. One

property can be exchanged for two or more properties. The only requirement is that all properties must be located in the United States. The rule is highly accommodating.

6. Are the 1031 exchange rules so complex that the cost of professional fees in consummating the transaction will eat up any capital gains tax savings my client might realize?

No. A plain vanilla 1031 exchange transaction where a seller of relinquished property uses an intermediary to exchange for a replacement property is a relatively simple proposition and the deferred capital gains tax can be significant. It is where the exchanger adds a complication--like the need to cash out a partner--that complexities arise. In many instances, such complexities can be accommodated by careful planning with a tax advisor. Depending on the facts, it may be possible to convey the property to each of the owners of the property-owning entity, individually as tenants-in-common, or to refinance the replacement property post-closing to cash out the departing partner. Consultation with a tax advisor should be part of structuring any 1031 exchange transaction.

7. My client just found out about the benefits of structuring her real property sale as a 1031 exchange. Is it too late? We're at the closing.

It's not too late. As long as the buyer will cooperate, a brief contract amendment can be executed at the table transforming the sale into a 1031 exchange. As long as the net sales proceeds are not be paid over to the seller or its agent, but to a qualified intermediary, federal and state capital gains tax can be deferred, provided the exchanger identifies replacement property within 45 days thereafter and closes on its purchase within 180 days from the sale of the relinquished property.

8. My client is a developer who is selling new homes she built. Can these sales properly be the subject of 1031 exchange transactions?

No. These properties are not investment properties as defined in IRC 1031, they are inventory, held for resale.

9. My client would like to apply a portion of the net proceeds arising from the sale of the Relinquished Property towards the renovation or construction of the Replacement Property. Is this permissible under IRC 1031?

No. To qualify for deferral of capital gains taxes under IRC 1031, net proceeds from the sale of the Relinquished Property must be applied to the purchase of a direct interest in real estate. Your client may apply a portion of such net proceeds to the renovation of the Replacement Property (or for any other purpose), but those proceeds so used will be treated as Boot and fully taxed. Alternatively, your client may wish to structure her 1031 transaction as a Construction Exchange (discussed below).

10. In a reverse exchange, should my client prefer a fee conveyance of the Replacement Property from the EAT holding title or a conveyance of 100% of the membership interest in the EAT? What are the advantages/disadvantages of either form of conveyance?

Neither method is preferable, although the equity transfer is likely simpler to effectuate. The EAT should be in fee title to the Replacement Property "as nominee for" the Exchangor, and, accordingly, in most if not all jurisdictions, there will be an exemption for transfer taxes. Similarly, the title insurance policy will insure the nominee once fee title is conveyed to it. The Replacement Property conveyance can also be accomplished by the QI's merely transferring 100% of the membership interest in the EAT to the Exchangor.

3. Conclusion

The number of 1031 exchange transactions has grown steadily since the 2013 increase in the capital gains tax rate. To offer effective representation, attorneys should be familiar with the mechanics of this cost-saving, real property investment-friendly feature of the I.R.C. Strategic use of the forward exchange, the reverse exchange or the construction exchange can defer a client's capital gains tax obligations arising out of a sale of investment property. Advising a client about the possibility of capital gains tax deferral should be on every attorney's client intake checklist.