BY: MICHAEL S. BRADY, ESQ., CES®

REVERSE EXCHANGES & END OF YEAR TAX BENEFITS

I. "Closer Look" at IRC §1031.

A. Internal Revenue Code §1031(a)(1) states:

No gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind which is to be held either for productive use in a trade or business or for investment.

B. In basic English, this provision simply means that to avoid paying taxes when you sell commercial real property, you must trade it for other real commercial property.

C. The basic mechanics of a 1031 Exchange can be understood simply by breaking down the language of IRC §1031(a):

1. **"No gain or loss shall be recognized…."** If capital gain is recognized for tax purposes in a transaction, the gain is subject to taxation. Accordingly, the goal of a properly structured exchange is to defer the recognition of capital gain. Important to note that the recognition of losses may also be deferred Dunder IRC 1031.

2. **"….on the exchange…."** The property cannot just simply be sold, it must be exchanged for other property. A sale of one property, followed by the purchase of another property is not an exchange of property. Accordingly it is critical that a 1031 exchange transaction be properly structured before any property is transferred. See Treas. Reg. 1.1031(k)-1(f)

3. **"….of property held for productive use in a trade or business or for investment…."** Not every property will qualify for tax deferral under IRC §1031. The property must have some commercial or investment use. A primary residence, for instance, will not qualify. A second home or vacation home will not qualify, unless the property is also rented. See Rev. Proc. 2008-16. How much rental vs. personal use is required is discussed later in these materials.

4. **"….if such property is exchanged solely for property of like kind…."** The property being acquired

by the taxpayer (the “Replacement Property”) must be “like kind” to the property the taxpayer is disposing of (the “Relinquished Property”). When it comes to real property, the definition of “like kind” is very broad. See Treas. Reg. 1.1031(a)-1(b). The properties do not necessarily have to have the same or similar use. For example a rental property could be exchanged for a factory, since both are commercial real property. However, when it comes to personal property, the definition is much narrower, ie. a taxpayer could not exchange an airplane for a bus.

5. **“....to be held for productive us in a trade or business or for investment.”** So in addition to being “like kind”, the Replacement Property must also be held for commercial or investment use. Again, for real estate, the use of the property does not need to be identical. But for personal property, the regulations are more restrictive. For example, a copyright for a novel cannot be exchanged for the copyright for a song. See Treas. Reg. 1.1031(a)-2(c)(3).

II. Deferring Taxes.

A. An exchange under IRC §1031 does not eliminate it taxes, it defers them. Once the taxpayer sells the Replacement Property (as opposed to completing another 1031 exchange), the taxpayer will recognize all gain , which will then be subject to taxation.

B. To fully defer taxes in a 1031 exchange, the taxpayer must:

1. Acquire property that is equal and greater in value to their Relinquished Property; and

2. Spend all of the net proceeds from the Relinquished Property in the acquisition of the Replacement Property.

Should the taxpayer do those two things, their mortgage debt will take care of itself.

Should the taxpayer fail to do these two things, the taxpayer will be deemed to have received “boot” or non like kind property. See generally Treasury Reg. §1.1031k-1(j)

C. Example – Fully deferred exchange:

	RELINQUISHED PROPERTY	REPLACEMENT PROPERTY	BOOT*
Sales Price	$1,000,000	$1,500,000	
Mortgage	--$300,000	$800,000	$0
Net Equity	$700,000	$700,000	$0

**The taxpayer received no boot and accordingly has fully deferred any taxation.*

III. Types of Exchanges.

A. **Two Party Swap**

1. The simplest, most “pure” for of 1031 Exchange.

2. Two parties simply trade like kind property. For real estate, each party would simply deed their property to the other party.

3. A swap is ideal if the properties involved are of the same value. Otherwise, the party receiving the less valuable property would need to receive cash or other property to make up the difference. This would result in taxable boot, unless it was used to acquire other like kind property.

4. A swap becomes more difficult if either of the two properties is encumbered by debt. If the debt on the two properties were equal, the parties could just assume the other parties debt. The exchange could also work if the debtor's lender agreed to accept the replacement property as substitute collateral for the relinquished property. Otherwise, where there is a disparity in the debt, cash would need to be involved, resulting potentially in the receipt of boot.

5. Since the parties interests very rarely perfectly align, swap transactions are not very common.

B. **The Delayed ("Deferred") Exchange using a Qualified Intermediary**

1. Treasury Regulation 1.1031(k)-1 governs "deferred exchanges." It permits a non-simultaneous exchange involving multiple parties, ie. an exchange does not need to be a swap.

2. The Qualified Intermediary (QI) safe harbor is provided for in Treas. Reg. §1.1031(k)-1(g)(4). The QI is defined as:

   A person who—

   (A) Is not the taxpayer or a disqualified person (as defined in paragraph (k) of this section, and

   (B) Enters into a written agreement with the taxpayer (the "exchange agreement") and, as required by the exchange agreement, acquires the relinquished property from the taxpayer, transfer the relinquished property, acquires the replacement property, and transfers the replacement property to the taxpayer.

3. A "Disqualified Person" would be any person who has acted as an agent of the taxpayer within a two year period prior to the sale of the Relinquished Property, including their:

   (a) Employees;

   (b) Investment Banker or Broker;

   (c) Real Estate Agent or Broker;

   (d) Attorney; or

   (e) Accountant

Services related to the 1031 exchange (but not the sale and purchase of the property) are not considered in making the determination of whether a party is a Disqualified Person, nor are routing financial, title insurance, escrow or trust services by a financial institution, title insurance company or escrow company. *[see Treas. Reg. 1.1031(k)-1(k)]*

A corporation or partnership will be considered disqualified if the taxpayer owns more than a 10 percent interest in that entity.

4. Under the Qualified Intermediary safe harbor, the taxpayer is essentially exchanging properties with the Qualified Intermediary. The taxpayer gives their relinquished property to the QI who then sells it

to a buyer. The QI then uses the sales proceeds from the relinquished property to purchase one or more replacement properties. The QI then, in turn, gives the replacement property to the taxpayer. The taxpayer has received property in exchange for property, as opposed to selling their property and then subsequently acquiring other property.

5. While the structure of the exchange for tax purposes is as outlined in the previous paragraph, the Treasury Department recognized that deferred exchanges would be overly complicated and complex if the QI was required to actually obtain ownership of the relinquished and replacement property. Accordingly, the regulations provide that is sufficient if the QI merely assigned the benefits of the respective contracts of sale, and the properties are deeded directly from the taxpayer to the buyer on the first leg of the transaction, and from the seller to the taxpayer on the second leg of the transaction. This is referred to as "direct deeding" *See Treas. Reg. §1.1031(k)-1(g)(4).*

6. The sales proceeds from the Relinquished Property flow through the Qualified Intermediary, the properties are deeded directly between the parties.

7. **Deadlines**. Very strict deadlines apply to deferred exchanges. The deadlines include weekends and holidays and there generally are no extensions available. (In certain cases, the IRS has extended the deadlines for taxpayers affected by a federally declared natural disaster. *See Rev. Proc. 2007-56, Section 17.)* The deadlines expire at midnight of the day in question. If multiple relinquished properties are included in the exchange, the deadlines run from the transfer of the first relinquished property.

8. **Identification Period**. The Replacement Property must be identified within 45 days from the transfer of the Relinquished Property. *See Treas. Reg. §1.1031(k)-1(b)(2).*

    a. The identification must:

        i. Be in writing;

        ii. Unambiguously describe the property (street address, legal description or distinguishable name)

        iii. Be hand delivered, mailed, telecopied, or otherwise sent before the end of the identification period to:

            (a). the Qualified Intermediary; or

            (b). the Seller; or

            (c). any other person involved in the exchange, such as an escrow agent or title company, other than the taxpayer or a disqualified person (ie. taxpayer's attorney, real estate agent or accountant).

            The identification can be revoked during the 45 day identification period, but must be done in the same manner as the identification, ie. in writing, signed by the taxpayer and mailed, telecopied or otherwise sent to the person to whom the original identification was sent.

    b. The Exchanger may identify multiple properties, within limits:

        i. **Three Property Rule**. The taxpayer may identify up to three properties regardless of the fair market value of the properties;

        ii. **200 Percent Rule**. The taxpayer may identify any number of properties provided the aggregate fair market value does not exceed 200 percent of the aggregate fair market value of all the relinquished properties.

iii. **95 Percent Rule**. If the taxpayer identifies more than three properties with an aggregate fair market value in excess of 200 percent of the fair market value of the relinquished properties, the taxpayer will be treated as having not identified any property, unless the taxpayer acquires at least 95% of the aggregate fair market value of all the properties identified before the end of the Exchange Period.

9. **Exchange Period**. From the date of the transfer of the relinquished property, the taxpayer must acquire its replacement property by the earlier of 180th day thereafter, or the due date (including extensions) of the taxpayer's tax return for the year in which the relinquished property was transferred. *See Treas. Reg. §1.1031(k)-1(b)(2)(ii)*.

C. **Reverse Exchange.**

Through a Reverse Exchange, the closing for the Replacement Property may occur before the closing for the Relinquished Property. However the taxpayer may not own both the Relinquished Property and the Replacement Property at the same time. To avoid this, title to either the Relinquished Property or the Replacement Property may be "parked" with an "Exchange Accommodation Titleholder", otherwise known as an "EAT," until the Relinquished Property can be transferred to the ultimate buyer. *See Rev. Proc. 2000-37.*

1. Because the structure is so much more complex, the fee is generally much higher.
2. The EAT is generally a single member LLC created and owned by the Qualified Intermediary or one of its affiliates.
3. In a Reverse Exchange, from the transfer of the parked property, the Relinquished Property must be identified with 45 days, and transferred to the ultimate buyer within 180 days.
4. In a safe harbor reverse exchange, the EAT may borrow the acquisition funds from the Exchanger, the EAT can lease the property to the Exchanger, and the EAT can enter into a property management agreement with the Exchanger.
5. The Exchanger and the EAT must enter into a "Qualified Exchange Accommodation Arrangement" within 5 business days of the property being transferred to the EAT.
6. Since a Reverse Exchange involves transferring a property twice, depending on the jurisdiction, there may be double transfer taxes. Strawman exemptions (RPT) and no-consideration exceptions may apply.
7. Additionally, discuss with title insurer whether the title insurance will be impacted by the transfer.
8. Lender's may object lending to an EAT. Likewise, if the Relinquished Property is transferred to the EAT, a mortgage due on sale provision could be triggered.
9. When parking the Relinquished Property, the Replacement Property debt and equity must match that of the Relinquished Property, or boot may result.

D. **Improvement Exchange.**

Using the same parking arrangement utilized for a Reverse Exchange, a taxpayer may use tax deferred dollars to add improvements to the Replacement Property.

1. Like the reverse exchange, title to the Replacement Property is "parked" with the EAT while the improvements are being made.

2. The EAT can enter into a construction agreement with the taxpayer.
3. The improvements must be completed with the Exchange Period of 180 days.
4. Both the Property and the improvements must be identified within 45 days.

IV. End of Year Exchange Planning.

With the end of the year rapidly approaching, it's time for all taxpayers to begin the dreaded annual ritual of gathering their tax related documents for the journey to the accountant's office. This is particularly true for investors involved in a 1031 exchange, but for them it's not just gathering their papers. Depending on the status of their exchange, the end of the year may present some deadlines to meet and some opportunities to explore.

A. **Know when your exchange must be completed.**

The maximum amount of time a taxpayer has to complete a 1031 exchange is 180 days. This "Exchange Period" runs from the date the taxpayer transfers the Relinquished Property to the buyer. The Replacement Property must then be acquired by the taxpayer by midnight of the 180th day thereafter.

However, the Exchange Period can be shorter than 180 days. IRC Section 1031 actually provides that the Replacement Property must be received by the **earliest** of the 180th day after the Relinquished Property is transferred, **OR** the due date, including extensions, for the tax return for the year in which the Relinquished Property was transferred.

For example—a taxpayer who sold Relinquished Property in 2015 would generally need to file their tax return and report their 1031 exchange by April 15, 2016. However, if they closed on the sale of the Relinquished Property between October 18, 2015 and December 31, 2015, the 180th day of their exchange would be April 15, 2016 or later—either on or after their tax filing deadline (Remember-2016 is a Leap Year). Since the 1031 exchange must be reported on the taxpayer's 2015 tax return, it must be completed before the tax return is filed.

However, all is not lost—if the exchange cannot be completed by April 15, the taxpayer can usually simply file for an automatic extension of six months to file their tax return. They would then have the benefit of the full 180 day exchange period.

It is important to note that corporations and certain non-calendar year taxpayers may have different tax filing due dates that will affect their Exchange Period. Additionally, the Exchange Period includes both weekends and holidays, and the only extensions that have been granted have been where a federally declared disaster occurred during the Exchange Period which impacted the 1031 exchange in one of several specifically designated circumstances.

What happens if Replacement Property is acquired after the Exchange Period? In Knight v. Commission, T.C. Memo. 1998-107, the tax court disallowed a 1031 exchange where the taxpayer did just that. Knight had argued that the IRS should be more "citizen-friendly", since they claimed they closed on their Replacement Property after the 180th day due to circumstances that were beyond their control. While sympathetic to taxpayer's plight, the court found that it was bound by the Internal Revenue Code, not principles of equity. The taxpayer was required to recognize their capital gain and pay the resulting taxes, despite having purchased the property.

B. **Take advantage of tax year straddles.**

Since Exchangers have up to 180 days to complete their 1031 exchange, many exchanges will wind up straddling two tax years. As a result, in a failed 1031 exchange the taxpayer may not be entitled to receive their funds until the year following the sale. While this can be a source of aggravation, the restriction can provide a tax benefit.

IRC §453 applies to property sales where at least one payment is received by the taxpayer in the year following the year of the sale. When this “installment method” applies, the payment is not subject to taxation until it is received. What this means is that if a failed 1031 exchange period straddles two tax years, the funds might not be taxed in the year of the sale, but rather in following year, essentially providing up to a year of tax deferral.

Of course, you should keep an eye open for changes in tax rates—when long term capital gain tax rates increased in 2013, the installment treatment was not an attractive option. As a result, many investors wisely opted out and chose to be taxed at the lower 2012 rates.

Additionally, to take advantage of installment sale treatment, the taxpayer must have had a bona fide intention to enter into a 1031 exchange at the time of the sale, such that it was reasonable to believe that replacement property would be acquired before the end of the exchange period.

Finally a taxpayers electing to take advantage of installment treatment should coordinate with their accountant regarding when the tax should be paid.

C. **Gather documents for your accountant.**

Ideally, a taxpayer will have consulted with their accountant before entering into a 1031 exchange so that the transaction is not a complete surprise when the tax return needs to be prepared. Regardless, the accountant will need certain information.

Form 8824 is the form used to report a 1031 exchange to the IRS. At a minimum, the following information and documents are needed to complete this form:

1. The closing statement for the sale of the Relinquished Property;
2. The closing statement from the purchase of the Replacement Property;
3. The account statement from the Qualified Intermediary; and
4. The date that the Replacement Property was identified;

The accountant will also need prior year’s tax returns to compute the adjusted basis of the Relinquished Property. They may also need the closing statements from when the Relinquished Property was originally acquired, as well as information regarding capital improvements that have been made to the Relinquished Property.

The end of the year provides a good opportunity to gather and organize information to ensure a smooth tax season.

D. **Begin 2016 Tax Planning**

If you are planning to sell a property in 2016, consider whether a 1031 exchange makes sense and plan accordingly.

If you have partners, discuss whether everyone wants to exchange and whether you plan to invest in a new Replacement property together. If not, you may want to restructure the manner in which title to the Relinquished Property is held, and you may want to do so before the New Year.

Talk to brokers about the potential market for your property. Property values have risen since the recession, and many regions are experiencing a seller's market. Knowing the value of your property and how quickly it can be sold will be essential to your planning.

Explore financing options for replacement properties. Interest rates have been low, but underwriting requirements have been strict.

Consider whether more passive investments, like Net Lease properties or Delaware Statutory Trusts make sense, and begin investigating the markets and sectors in which you might want to reinvest. If you find an ideal Replacement Property now, a Reverse 1031 Exchange might make sense if you don't yet have a buyer for your Relinquished Property.

Most importantly, discuss your transaction with a knowledgeable 1031 exchange qualified intermediary, who can alert you potential issues and offer potential solutions. The sooner you begin to plan, the more likely you will have a smooth exchange, and acquire the ideal and profitable Replacement Property.