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Steps to ensure a successful “safe harbor” 1031 exchange

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The adage “the devil is in the details” could never be more true than when an investor is performing a 1031 exchange. As the details cover a wide range of issues, the investor as well as his or her counsel and CPA all need to be knowledgeable about the steps involved and active in the process to ensure the exchange will be properly executed. Listed below is a summary of significant steps that should be addressed in any exchange. The summary pertains to a delayed or forward exchange though many of the steps also apply to reverse and improvement exchanges, albeit in a different order.

Select a Qualified Intermediary (QI). Investors seeking to take advantage of the “safe harbor” provisions of the code must engage a QI or similar entity to facilitate the

exchange. An investor should always conduct due diligence on a QI before engaging one to facilitate an exchange. The investor should verify that the selected QI has financial backing, years of experience facilitating 1031 exchanges and solid expertise concentrated in 1031 exchanges. Investors must be especially diligent in their evaluation as QI are not regulated at the Federal level and only by a few states.

Qualify the relinquished property. In 1031 exchanges, both the relinquished and the replacement properties must qualify as having been “held for productive use in a trade or business or for investment.” Many practitioners forget to qualify the transaction. Whether property is “held for investment” as defined by the IRS is dependent on many factors. The fact that property is being sold at a profit is insufficient in and of itself to establish investment intent.

Include cooperation clause in 1031 contracts. IRC 1031 requires that notice of the fact that a contract for purchase or sale is to be assigned to a

QI be provided to the other party to the contract in writing before closing. Many advisors recommended that language be inserted in the contract for sale of the relinquished property and purchase of the replacement property indicating that an exchange is to be performed and that the contract is to be assigned to a QI.

Identify the tax owner. In most cases, the tax and legal owner of the relinquished property are the same person or entity. However, this may not always be the case. Where for instance the deed to the relinquished property is in the names of three individuals but where the tax returns for the property have been filed for years in the name of the partnership and all actions with respect to the property have been carried on in the partnership name. In the case where inconsistency exists between the legal owner and the tax owner, it is up to the investor’s legal advisors to determine which person or entity is the tax owner of the property as the tax owner is the

owner with the legal standing to perform an exchange.

Special issues for entity exchangers. One of the most common issues in performing a 1031 exchange in today’s market concerns the issue of what to do when investors who own property in a multi-member LLC wish to independently exchange their membership interests. One cannot purchase or sell a membership or partnership interest in a tax deferred exchange as such interests are specifically excluded from what is considered qualifying property under the code. If an exchange involves this potential issue, identifying it as an issue as early as possible is important. There are a number of legal and tax issues that arise in connection with converting to TIC ownership and converting to TIC form of ownership does not in itself result in each investor being qualified to independently exchange his or her interest. Especially where the conversion occurs soon before a sale, there may be a risk that the IRS could question whether the tenant in common ownership interest was

held with investment intent as required under 1031.

Ensure timely execution of exchange documents. There are still some investors that do not realize that one must have exchange documents prepared by the qualified intermediary and executed at closing to effect an exchange. Once closing has occurred, an investor has constructive receipt of the proceeds and a taxable event has occurred even if the funds are held in an attorney's escrow account. Thus, it is too late to open an exchange after closing. While an investor may be able to rescind the sale, open an exchange and then close again, to accomplish this, every party to the transaction must be returned to the state they were in prior to closing and all funds remitted to the payors. In today's marketplace, this makes rescission in order to accomplish an exchange a very difficult option.

Distribute proceeds to ensure no boot. If any part of the gross sale proceeds is used to pay costs or fees that do not constitute transactional costs or mortgage debt as defined in the Code, such portion of the proceeds will be taxable to the investor as boot. The most common error made by closing counsel and their clients is to deduct taxes or other prorated items or security deposits to be credited to the buyer from the proceeds. These costs are not transactional costs and will be taxable to the investor. Similarly, if the seller was to repair the property and failed to do so, deducting the cost of the repairs from the proceeds will likewise result in boot equal to the amount so deducted. To the extent such

costs are deductible, this fact may not matter to the investor but all should be aware of the consequences of such payments. In contrast, broker's commissions, transfer taxes, legal fees and other expenses typically incurred in connection with the purchase and sale of real property are considered transactional expenses, the payment of which will not result in boot.

Identify replacement property timely and properly. The investor performing the exchange is required to provide written notice unambiguously describing all of the potential replacement property the investor may wish to acquire in its exchange within 45 calendar days of the date on which the relinquished property is sold. In addition, the notice must comply with one of three technical rules. Most investors understand this but not necessarily how the rules apply. The three property rule means exactly that—three properties can be identified without regard to their fair market value. But trouble arises when one tries to determine what constitutes one property. Do two contiguous lots used as one townhome constitute one property? Does an office park containing several lots with many buildings located within it constitute one property? If not, what are an investor's options? The primary option available if all properties an investor wishes to list may total more than three is to use the second of the three available rules, the 200% rule. An unlimited number of properties may be listed as long as the total value of the properties listed does

not exceed twice the value of the properties sold, this rule will be satisfied. The other primary obstacle that occurs in the identification process is how to unambiguously describe a particular property. A street address or legal description might not be sufficient. For instance, where there are multiple units at one address, a unit, suite or apartment number is also essential. Where a fractional interest in a property is to be acquired and not 100% of the fee, it is essential to list the percentage interest to be acquired.

Reinvest all net equity within the exchange period.

The net equity is the difference between the gross sales prices and the mortgage debt and transactional costs. The net equity must be invested in replacement property within the exchange period to avoid boot. In addition, the replacement property must be at least equal to the net value (sale proceeds less transactional costs) of the relinquished property. The balance of the purchase price above the net equity can be mortgage debt. Many advisors do not realize that one cannot pocket cash and achieve 100% deferral though partially deferred exchanges are permissible.

Verify replacement property is qualifying real property interest. Once the replacement property is identified, many advisors fail to confirm that the investor also intends to hold the replacement property for use in a trade or business or for investment. The intent to convert the replacement property to one's primary residence or to list it for resale soon

after acquisition will likely disqualify the exchange.

Timely filing tax reporting forms. Form 8824 is the form used to report to the IRS that an exchange has occurred. While the IRC is not explicit with respect to the requirement to file Form 8824 per se, other Code sections provide the IRS with legal authority to require its filing. Thus, most prudent exchangers in fact file the form with the tax return for the year in which the exchange is commenced. Investors who do not purchase their replacement property until after their tax return is due must obtain an extension of their tax filing date to enable them to demonstrate the exchange and deferral on their tax return. This extension is also needed to enable an investor to take advantage of the maximum 180 calendar day time period to effect an exchange when the tax return due date falls on an earlier date. Note that in Treasury Report, dated September 17, 2007, Reference No. 2007-30-172, the IRS was directed to provide further guidance to investors regarding the use and filing of this form.

The above is only a summary of some of the issues which arise in connection with an exchange. Many other issues may require attention as well depending on the investor's facts and circumstances. As always, therefore, prudent investors should consult with their legal and tax advisors before proceeding.

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