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Enriching Clients Through IRC §1031 Tax-Deferred Exchanges

By John E. Mayer

SPECIAL FEATURE

Real Property

Growing law firms compete for high-quality clients by finding new, cost-efficient ways to add value to their services. Clearly, the greater the value of the firm's service to the client, the more valuable the client will become to the firm in ongoing business and high-end referrals.

A working understanding of IRC §1031 — and of professional contacts who can design and facilitate these tax deferred exchanges of real or personal property — equips an attorney, trustee, or other fiduciary with the ability to help clients take advantage of one of the last great opportunities to save taxes and build wealth. Indeed, as awareness of this opportunity grows, the dollar value of exchanges has increased to more than $55 billion per year.

Properly using an IRC §1031 exchange, a client with investment property or real property used in their business can sell the property, use *all* of the equity to acquire replacement property, and defer the capital gains tax that would ordinarily be paid.

The replacement property can be of equal or greater financial value, and it is almost always more suitable to the current needs and purposes of the client.

Benefits To Clients

An attorney who helps clients defer significant capital gains taxes obviously provides a valuable service. In addition, an IRC §1031 exchange can present a number of other important solutions and benefits to clients.

A client with fully depreciated property may exchange it for higher value, depreciable property, or exchange slowly appreciating property for faster appreciating property, or difficult-to-sell property for property that may be easier to sell in coming years.

Sometimes a client needs greater cash flow. She can exchange a lower-cash-flow property for a higher-cash-flow property, or she can exchange non income-producing land for improved property that provides rental income, or property that cannot be refinanced, such as vacant land, for improved property that can be refinanced.

Moreover, a client may sometimes need to exchange an investment property for property she can use in her business. A doctor, for example, may desire to exchange a rental house for a medical building to use in her practice. Clients who own growing businesses may need property that will better accommodate the current and future needs of their businesses.

As clients go through changes in life, retire, or prepare to pass on their estates, a tax-deferred exchange can create a better situation for today and tomorrow.

If a client has moved to a different part of the country, she may wish to exchange her current property for investment property near her new home. Or, if she wants to spend more time traveling or enjoying retirement, she may wish to exchange her current property for investment property that requires less oversight.

For greater peace of mind, she may wisely wish to diversify her property holdings. In preparing an estate, a client may wish to exchange a larger piece of property for several smaller properties that can more easily be distributed to children.

Actually, one or more properties can serve as the relinquished property and one or more properties can serve as the replacement property, in any combination, as long as the re-

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placement property is of equal or greater value than the relinquished property. This feature in itself provides a number of potentially helpful solutions to clients who need to readjust their investments, especially those who realize the need to diversify their real estate investments.

Other opportunities to take wise advantage of IRC §1031 abound. Simply put, the point is this: Attorneys can add real value for their clients if they know enough about IRC §1031 provisions to spot situations where an exchange could be highly beneficial. They also need to know who to bring in to design and help facilitate the exchange, including the all-important task of identifying appropriate replacement property within the time limits of the exchange and the investment needs of the client, a juncture where many exchange efforts fail.

While IRC §1031 exchanges are sound, well-supported procedures, they can be quite complex. Seemingly minor mistakes may cause the effort to fail and result in a significant tax event.

Consequently, the following description of IRC §1031 exchanges is meant to provide a working understanding of this provision rather than a roadmap to follow in attempting to design or facilitate an exchange.

The treatment below deals with investment property or real property used in a business, not personal property. For information on three recently provided safe harbors for IRC §1031 exchanges of personal property, see Rev. Proc 2003-39 and 2003-22 IRB 1.

Essential Elements

Essentially, the §1031 exchange involves two main steps: 1) exchanging or selling the existing property or properties in a manner that meets IRS requirements to qualify for a tax-free exchange; and 2) identifying replacement properties that provide better diversification, an opportunity for growth, and current returns in the form of cash flow, in order to provide the peace of mind the exchanger is seeking.

Successful completion of these two steps demands attention to some key requirements of all IRC §1031 exchanges.

The first key requirement for an IRC §1031 exchange is that the exchanger must sell or relinquish property and buy a replacement property of "like kind" in a reciprocal trade.

The term "like kind" refers to the nature or character of the property, not to its grade or quality. It refers also to the client's intent to use the property for investment purposes or for productive use in their business (i.e., an office building), rather than for personal use (i.e., a second home).

For example, clients may exchange residential for commercial property, bare land for rental property, fee simple interest for a 30-year leasehold, single family rental for multi-family rental, corporate twin-engine aircraft for a corporate jet, garbage routes for better garbage routes, and so forth.

Clients may *not* exchange properties such as stocks, bonds, notes, certificates of trust, interest in partnerships, debt securities, and the like.

A second key requirement for an IRC §1031 exchange concerns the parties involved — exchanges cannot occur among relatives, business partners or companies that are part of the same entity.

A third key requirement for an IRC §1031 exchange is that the exchanger cannot receive cash or other benefits in the exchange unless she pays capital gains taxes on that portion of the exchange.

Therefore, to avoid paying capital gains taxes, clients should purchase a replacement property of equal or greater value than that of the relinquished property. They should then reinvest all of the equity into the replacement property, and obtain an equal or greater amount of debt on the replacement property (unless they choose to offset some of the debt on the replacement property by putting an equivalent amount of additional cash into the exchange).

A fourth key requirement is that a reciprocal trade or actual exchange must take place — this is why the client should utilize a qualified intermediary to complete the exchange. The exchanger assigns to the intermediary her interest as seller of the relinquished property and her interest as buyer of the replacement property.

This arrangement enables the exchange to be a reciprocal trade regardless of the number of properties and parties in the exchange transaction. The intermediary receives, holds, and disburses proceeds from the transactions, prepares legal documentation specific to the exchange, tracks compliance with IRS Form 8824 requirements, provides fidelity bond insurance coverage, and a written guarantee of security backed by a third party, usually a national insurance company.

By receiving, holding, and disbursing the proceeds, the qualified intermediary controls the proceeds. This protects the exchanger from "actual or constructive receipt" of proceeds during the exchange, an event that would cause the tax-deferred exchange to fail.

The exchanger cannot receive cash or other benefits in the exchange, unless she pays capital gains taxes on that portion of the exchange, nor can the exchanger have control of the proceeds during the exchange without incurring "constructive receipt."

The constructive receipt issue brings up another reason why a qualified intermediary is essential. Anyone who has functioned as an agent of the exchanger — attorney, accountant, employee, investment banker or broker, real estate agent or broker — during the two-year period prior to the date of the transfer of the first relinquished property is considered a disqualified person.

If an exchanger's agent serves as the facilitator of the exchange, the IRS will rule that the exchanger had control and therefore had "actual or constructive receipt" of the exchange funds. Although the client's attorney, or other agents, should not serve as the qualified intermediary in an exchange, the attorney can nonetheless serve as an invaluable advisor during the exchange.

A fifth key requirement for an IRC §1031 exchange is that the exchanger must adhere to strict time limits to complete the exchange transaction. The IRS allows absolutely no extensions.

Specifically, the exchanger has 45 days from the closing date on the relinquished property or properties to identify the potential replacement property or properties by providing written notice of the address(es) or legal description(s) to the intermediary. The purchase of the replacement property or properties must occur within 180 days after the close of the first relinquished property or properties.

Types Of IRC §1031 Exchanges

Depending upon their specific needs, clients may utilize one of several types of IRC §1031 Exchanges: the simultaneous exchange, the delayed exchange, the build-to-suit exchange, or the reverse exchange.

• *Simultaneous exchange* — In the simultaneous exchange, the exchanger enters into the exchange agreement and assignments with the qualified intermediary, who receives the relinquished property and acquires the replacement property for the exchange, thus creating the "reciprocal trade" and ensures the preservation of "safe harbor" treatment under the 1991 Treasury Regulations.

The buyer transfers cash for the relinquished property to the qualified intermediary, and the exchanger directly deeds the relinquished property to the buyer. The intermediary transfers cash for the replacement property to its seller, who directly deeds the replacement property to the exchanger.

• *Delayed exchange* — This is the most common. The exchanger enters into the exchange agreement and assigns the rights in the sale contract for the relinquished property and in the purchase contract for the replacement property to the qualified intermediary.

Within 45 days of the close of the first relinquished property, the exchanger must provide written identification of the replacement property, and must close on the last replacement property with 180 days of the close of the first relinquished property. Without professional assistance to identify appropriate replacement property, exchangers often fumble the exchange at this juncture.

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• *Build-to-suit exchange* — This follows the same general process as the delayed exchange. However, it allows the exchanger to use the exchange funds to improve or construct the replacement property.

The exchanger may renovate existing improved property or build a new improvement on raw land. However, the new construction cannot take place on land already owned by the exchanger.

Any improvements or new construction must be built and paid for prior to the close of the exchange when the exchanger takes title to the replacement property. Additional construction may take place after this time, but the value of the improvements may not be considered part of the exchange.

• *Reverse exchange* — This is a more difficult and risky transaction. The simultaneous, delayed, and build-to-suit exchanges can depend upon the "safe harbors" provided by IRC §1031. But the tax regulations do not explicitly support the "reverse exchange" where the replacement property is acquired before the relinquished property is sold.

However, there are cases that have supported reverse exchanges, and these do provide guidance when it is absolutely necessary for the client to acquire the replacement property first.

In a typical reverse exchange, the exchanger contracts to have the qualified intermediary purchase, close and retain title to the replacement property. The exchanger loans the intermediary the cash for the down payment on the replacement property. The intermediary often hires the exchanger as the property manager, or leases the property to the exchanger or a third-party tenant under a triple net lease. This allows the exchanger to benefit from use of the property while the intermediary holds title.

When the exchanger finds a buyer for the relinquished property, the cash for the purchase goes to the qualified intermediary and the exchanger directly deeds the relinquished property to the buyer. The intermediary uses the cash to repay the exchanger's loan for the down payment and pays down any mortgage owed on the property. After all proceeds are paid out of the account, the intermediary deeds the property to the exchanger.

Opportunity To Serve

Obviously, there are many important details and considerations involved in these complex — but sound — transactions that cannot be covered in the scope of this article.

However, a raised consciousness regarding IRC §1031 exchanges, and a general working understanding of their extremely valuable potential benefits to clients, may provide fertile ground for new business at many law firms.

Given the huge value of appreciated investment property in many clients' portfolios —and their increasing need to diversify these holdings while deferring taxes — this area alone could constitute a serious practice in sophisticated firms.