THE TAX SAVINGS VALUE OF REAL ESTATE LIKE KIND PROPERTY EXCHANGES

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I. INTRODUCTION

Real estate like kind property exchanges under Section 1031 of the Internal Revenue Code provide real estate investors with the opportunity for significant tax savings by deferring the capital gains taxes on conveyed property. When an investor is considering the sale of investment property, but still wants to remain an investor, the individual should examine the possibility of qualifying for a Section 1031 exchange. In a normal sale of real estate investment property, the property owner is taxed on any gain realized from the sale of the property. Under the current tax law, the maximum tax rate on long-term capital gains for individual taxpayers is 15%. Since most states also tax the realized gain from the sale of investment property, a federal and state combined tax rate of 20% or higher on the realized gain from the sale of investment property is common.

Under the existing tax code, investment property may be sold and new investment property purchased through a Section 1031 exchange and the tax on the gain deferred until the replacement property is eventually sold in the future. At that point in time, the deferred gain and any additional gain realized on the replacement property, since the time of purchase is subject to tax. However, as long as the IRS rules are met, the replacement property may also be exchanged for new investment property, and the capital gains tax deferred again if another Section 1031 transaction is used.

In recent years the use of real estate like kind property exchanges under Section 1031 of the IRC has been increasing as a result of the tax saving available to real estate investors and recent IRS rulings which more broadly interpret the Section 1031 regulations[1].

II. REQUIREMENTS FOR REAL ESTATE LIKE KIND PROPERTY EXCHANGES

Under the current IRS rulings, the like kind property exchange has evolved into a purely financial transaction. An actual exchange between the same two parties is not necessary. A real estate investor can sell an investment property to one party and buy another investment property from another property owner and defer the gain under Section 1031. However, the regulations are extensive and any violation will throw out the

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[1] E. John Wagner II, *Ruling Paves the Way for Professionals to Operate Section 1031 Exchange Intermediaries*, JOURNAL OF TAXATION, V99 I6, 349-357, (DECEMBER, 2003).

opportunity for deferring the capital gains tax. There are several requirements for deferring the gains for real estate like kind property exchanges under Section 1031[2]:

- The investment properties exchanged must be of like kind.
- The replacement property cost must equal or exceed the cost of the relinquished property.
- The transaction must qualify as an exchange and not be deemed a sale of investment property.
- The investor must not receive any cash from the transaction.
- The property transferred and the property received must be held for investment purposes.
- The investor must meet the specified timing requirements.
- Title to the replacement property must be received in the same manner as the relinquished property.

If any of the requirements are not met, any gain or loss on the transaction must be recognized in the tax year of the investor and the capital gains taxes paid.

First of all, the tax code definition of "like kind" property for real estate is very broad. Any real estate held for investment purposes is eligible for a Section 1031 exchange. This includes commercial real estate, residential rental property and undeveloped land. Any type of investment property may be exchanged for another investment property[3]. For example, an apartment building may be exchanged for another apartment house, a commercial property, or undeveloped land or any combination of types of properties provided the IRS rules are followed. Multiple properties may be sold or purchased under one qualified exchange.

Next, in order to defer gain recognition, the replacement property cost must equal or exceed the net sales price of the relinquished property and the taxpayer must replace all debt and equity. Also, to avoid recognizing any gain, the taxpayer must not receive any cash from the sale[4]. To meet this requirement, most investors doing like kind property exchanges utilize the services of a qualified intermediary to handle the funds and mandatory requirements. This is a wise course of action, since the rules are complex and substantial tax savings are at risk.

Also, to successfully complete a real estate like kind property exchange, an investor must identify potential replacement property within 45 days of selling the relinquished property and must receive title to the replacement property within 180 days of the sale of the relinquished property. Recent IRS rulings give some flexibility for identifying replacement property within the 45 days rule[5]:

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[2] John R. Leavins, Samuel Penkar, *An Overview of Real Estate Like-Kind Exchanges,* APPRAISAL JOURNAL, V71 I3, 266-271, (JULY, 2003).
[3] Vesta Strategies, LLC, *Like-Kind Property,* at http://www.iag1031.com/exchangebasics.asp (last visited January, 2004)
[4] Jim Hamill, *New Ruling Relieves Partnership Like-Kind Exchange Concern,* EXECUTIVE'S TAX & MANAGAMENT REPORT, V66 I16, 4, (AUGUST, 2003).
[5] William J. Coffey, Lewis Schier, *Like-Kind Real Estate Exchanges under IRC Section 1031*, THE CPA JOURNAL, V71 I11, 58-59, (NOVEMBER 2001).

- The three property rule allows the investor to identify up to three replacement properties without regard to the total market value.
- The 200% rule allows the investor to identify any number of properties provided the aggregate fair market value of the identified potential replacement properties does not exceed 200% of the fair market value of the relinquished property on its date of sale.

The real estate investor must also take title to the property he or she ultimately buys in the same manner as the relinquished property[6]. For example, a sole owner of a fee simple interest in a real estate investment property cannot exchange it for a limited partnership interest in a larger commercial complex. The same title requirement generally restricts an investor from selling one property and buying a share in a larger investment property. When a potentially more attractive investment property opportunity arises, the taxpayer may examine the potential benefits of not using a Section 1031 exchange. However, after examining the after tax cash flow from the sale of a non tax deferred transaction, the investor may prefer an investment which will qualify for Section 1031 in order to receive the tax savings.

The 180 days rule for real estate like kind property exchanges is a major obstacle for some investors. In response to the need to buy a real estate replacement investment within the 180 days limit, a number of companies have begun offering “tenancy in common” interests as replacement investment property. There was a concern that the tenancy in common interests would be viewed by the IRS as essentially partnership interests, thus disallowing the tax deferred benefits of an exchange. To address the use of fractional ownership interests as replacement investment property in IRC Section 1031 exchanges, the IRS released revenue procedure 2002-22 in March, 2002 which detailed the requirements for tenancy in common interests to qualify. The following requirements were spelled out:

- The maximum number of tenants-in-common interests permitted is 35.
- The sponsor or organizer of the interests may own the property (or an interest therein) for only six months before selling 100% of the units.
- Unanimous decisions are required on anything of material or economic impact to the property or its owners.
- The management agreement (if applicable) must be at a market rate and renewable annually.

The IRS guidance has opened the door to a new real estate investment product which allows some flexibility when completing an exchange[7].

To meet the above requirements for a Section 1031 exchange, most real estate investors engage the services of a qualified intermediary. A qualified intermediary is a professional provider of the mandatory mechanics of an exchange. He or she is an independent party hired by the investor specifically to facilitate a tax-deferred exchange.

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[6] Jim Hamill, *New Ruling Relieves Partnership Like-Kind Exchange Concern*, EXECUTIVE’S TAX & MANAGAMENT REPORT, V66 I16, 4, (AUGUST, 2003).

[7] Ronald L. Raitz, Rob Hannah, *IRS Expands Replacement Property in 1031 Exchanges*, JOURNAL OF ACCOUNTANCY, V194 I1, 69, (JULY 2002).

When the investor uses the services of a qualified intermediary, the IRS does not consider the taxpayer to be in receipt of the funds from a sale of investment property. The sale proceeds go directly to the qualified intermediary, who holds the funds until the funds are used to purchase the replacement property. The funds are delivered directly to the closing agent who transfers the replacement investment property interest to the investor[8]. Violation of any of the IRC rules or time periods will disqualify the transaction for capital gains deferral.

III. COMMON TYPES OF SECTION 1031 EXCHANGES

The Internal Revenue Code Section 1031, has been used by real estate investors for many years to defer the payment of capital gains taxes on property held for investment. As originally enacted into law in 1921 only simultaneous like kind property exchanges were used.

A. SIMULTANEOUS EXCHANGES

In a simultaneous real estate like kind property exchange, a real estate investor has identified a new investment property or properties of equal or greater value than the intended property to be relinquished and the two or more properties are exchanged concurrently. The titles to the properties are conveyed in the same closing of escrow, guided by the qualified intermediary coordinating the exchange. Over the years there have been several major amendments to the tax code governing Section 1031 tax deferred exchanges. Today there are many different types of real estate like kind property exchanges available to real estate investors under the code.

B. DEFERRED OR DELAYED EXCHANGES

The most common real estate like kind property exchange today is the deferred exchange. The deferred exchange is also commonly called a delayed exchange. The investor relinquishes (sells) property at one point in time and receives replacement property (buys) at a later point in time. The entire process must be completed in the 180 days limit. The process begins with the close of escrow of the relinquished property. From that date, an investor has a maximum of 45 days to identify the potential replacement properties to complete the exchanges. After the 45 days period, the investor has an additional 135 days to complete the purchase of one or more of the properties identified. The transaction must be completed and title to the new property received within a total of 180 days of the close of title of the relinquished property. To avoid actual or constructive receipt of money and to qualify for the safe harbor provisions of

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[8] Federation of Exchange Accommodators, Professional Trade Association for Qualified Intermediaries Under IRC 1031, *About Accommodators & Qualified Intermediaries*, at http://www.1031.org/about1031/accommodators.htm (last visited October 13, 2004)

Treasury Regulations Section 1.1031(k)-1(g)(4) most deferred exchanges use a qualified intermediary as the third party to accomplish the deferred exchange.

In a deferred exchange, the qualified intermediary receives the funds from the sale of the relinquished property under a written agreement and facilitates the sale of the relinquished property and the acquisition of the replacement property. The investor must not receive or have the right to receive, pledge, or borrow any benefits of the money or property held by the qualified intermediary before the end of the exchange period. [Treasury Regulations Section 1.1031(k)-1(g)(4)][9].

C. REVERSE EXCHANGE

In a reverse exchange, the real estate investor acquires the replacement property before transferring the relinquished property. This could occur for many reasons, especially if problems arise in the planned transfer of the property to be relinquished or a new replacement property is found before a buyer was found for the old property. Although reverse exchanges have been used for years, there was virtually no guidance from the IRS on qualifying reverse exchanges until Revenue Procedure 2000-37 (IRB 2000-40), September 15, 2000. This reverse procedure provides a safe harbor under which the IRS will not challenge reverse exchanges for tax deferral purposes if the property is held in a “qualified exchange accommodation”. To meet this requirement, an investor must enlist the services of an accommodation party who acquires and holds the replacement property until the relinquished property can be sold. At this time, the replacement property is transferred from the accommodation party to the investor to complete the exchange[10]. The IRS requires that the accommodation party bear the risk of ownership during the holding period.

D. CONSTRUCTION EXCHANGE

A construction exchange may be used by an investor when he or she desires to relinquish an existing investment property and purchase a lot or undeveloped land and build the replacement property. In order to properly execute this type of Section 1031 exchange, a qualified intermediary is ordinarily used to purchase the land and hold the title to it during the construction period until the cost of the lot and improvements equals or exceeds the value of the property being relinquished. Investors may use either a deferred exchange or a reverse exchange when building the replacement property to be used in a construction exchange. Again careful attention needs to be given to meeting all of the previously discussed requirements for completing a Section 1031 exchange[11].

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[9] Linda Garrett Levy, Richard L. Levy and J. David Mason, *New Safe Harbor for Reverse Like-Kind Exchanges*, THE CPA JOURNAL, V73 I1, 42-48, (JANUARY 2003).

[10] Linda Garrett Levy, Richard L. Levy and J. David Mason, *New Safe Harbor for Reverse Like-Kind Exchanges*, THE CPA JOURNAL, V73 I1, 42-48, (JANUARY 2003).

[11] Ronald L. Raitz, Bridgette M. Raitz, *Beyond Section 1031*, JOURNAL OF ACCOUNTANCY, V190 I1, 61-67, (JULY 2000).

IV. SECTION 1031 TAX SAVINGS BENEFITS

The new rules on qualifying for a Section 1031 exchange allow investment property owners to sell their property to one party and buy other "like kind" property from another party and defer the capital gains tax on the sale. The potential for significant tax savings for investors when qualifying for a Section 1031 exchange has made this type of real estate transaction extremely popular among real estate investors and is worth serious consideration for any seller of investment property who wants to remain invested in real estate. Deferring the tax on the qualified exchange can save an investor thousands of dollars in taxes compared to a similar transaction involving the sale of one investment property and the purchase of another. Table 1, which is included in the appendix, illustrates the potential tax savings when qualifying for a Section 1031 exchange.

For example, if an investor purchased income producing real estate in 1994 for a purchase price of $150,000, with the average annual appreciation rate for investment property over the past 10 years, the current market value of his or her property in 2004 would be over $240,000. After 10 years of depreciation write offs for residential income producing property using the mandated 27½ years straight line method, and assuming a 20% allocation to land, an original depreciable amount of $120,000 would result in a current adjusted basis of $106,364. In a non tax deferred sale of the property, the investor would realize a $133,636 taxable gain on the sale and federal capital gains taxes of $20,045 at the current maximum federal capital gains tax rate of 15%. Most states also levy taxes on the realized gain so that the total taxes due for the tax year of sale for the investor would be higher.

V. OTHER BENEFITS

In addition to the direct capital gains tax deferral available under Section 1031, investors can benefit in a number of other ways by using Section 1031 exchanges. For example, an investor who moves for job relocation or any other reason can exchange investment properties located at his or her former geographic location for properties located near his or her new home. This allows investors to continue maintaining investment properties close to home without reducing their equity by the amount needed to cover the taxes of a non tax deferred transaction. Management and travel costs may be reduced by having the investment property close to home. Also, investors may exchange lower producing properties for potentially higher producing properties without incurring the tax on the sale. But most importantly, Section 1031 exchanges provide investors with greater investment appreciation opportunities by deferring a potentially large tax bill. The money that would ordinarily be paid in taxes can remain invested and thus continue earning a return to the investor.

VI. CONCLUSION

Real estate investors under Section 1031 have the opportunity for substantial tax savings and other benefits. If the proper formalities specified in the tax code are observed, the capital gains taxes payable in connection with an investment property sale are deferred. Whenever a real estate investor is considering the sale of investment property, the use of the Section 1031 exchange should be explored. Generally, the only time an investor should sell property instead of qualifying for a Section 1031 exchange is when the investor no longer wants to be a landlord or the tax on the sale is less than the cost of doing an exchange. Many of the major financial institutions have subsidiaries which facilitate Section 1031 trades by acting as intermediaries in the nature of escrow agents. There is growing competition to provide this service and the fees are relatively competitive and nominal compared to the potential tax savings. An exchange accommodator's fee for serving as a qualified intermediary is usually less than $1,000[12].

[12] *1031 Exchange: Why Should You Consider a 1031 Exchange?*, 2004 DOW JONES REUTERS BUSINESS INTERACTIVE LLC (TRADING AS FACTIVIA), (2004).

APPENDIX

Table 1 Potential Tax Savings of Section 1031 Exchanges

	Non Tax Deferred Transaction	Section 1031 Transaction*
Original Purchase Price (year of purchase 1994)	$150,000	$150,000
Estimated Current Market Value (year of sale 2004) after selling expenses	$240,000	$240,000
Less:		
Adjusted Basis at Time of Sale	$106,364	$106,364
Taxable Gain on Sale	$133,636	$133,636
Tax on Sale:		
Federal Capital Gains at 15%	$20,045	Tax Deferred
Assuming 5% State Tax (State tax rates vary)	$6,682	Tax Deferred
Total Tax on Sale	$26,727	Tax Deferred
Potential Tax Savings	------------	$26,272
* Taxable gain is deferred until the replacement property is sold.		