Farr Law Firm Newsletter
Big City Solutions. Small Town Values.
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1031 Exchanges

Fundamental Rules Revisited as the Real Estate Market Improves

In 2004 I wrote a newsletter that set forth the basic ground rules for 1031 exchanges (also referred to as like-kind, deferred, delayed, and Starker exchanges), the primary method of deferring capital gains taxes from the sale of investment property until the later sale of the property you acquired to replace the property you sold. We have left that newsletter on the Farr Law Firm website because, other than the tax rates (now 15% to 23.8% depending on your tax bracket vs. a flat 15% in 2004), not much has changed in the information presented there.

What has changed in the last nine years, however, is the real estate market. When real estate values started to decline in 2007 and 2008, it became harder to find sellers who met the obvious first criteria needed to consider an exchange: gain! If you are not going to have a gain on the sale of your property, then you will not have a capital gains tax you need to avoid by doing an exchange. That is the first issue I discuss with sellers who ask about exchanges. For the last several years that has made for many short discussions.

One might consider the bottom of the real estate market in Charlotte County was reached in January 2011 when the median sale price of single family homes was just over $80,000. That number for the last eight months (March to October 2013) has bounced around the $130,000 to $150,000 range, an increase of 62% to 87%. While most (but not all) exchanges we deal with are of the non-residential real estate variety, those residential numbers are an indication of increasing overall market health.

With that health has come many more inquiries about 1031 exchanges leading to several exchange closings in the last few months. Thus it is appropriate to review some of the fundamental rules relating to exchanges:

1. Both the relinquished property and the replacement property need to be held for investment purposes or for use in a trade or business. It does not matter what the actual use or zoning of the properties are. You can exchange a US 41 strip center for a waterfront vacant residential lot. Certain leaseholds also qualify as like-kind, but U.S. real property interests are not like-kind with foreign real property interests.
2. While a 1031 exchange can be used for real property and many classes of like-kind personal property (e.g., a cow for a cow, but not a cow for a bull, and a copyright of a novel for a copyright of a different novel, but not of a song), it does not apply to the following: stock in trade or other property held primarily for sale, stocks, bonds, notes, certificates of trust, beneficial interests, partnership interests, securities, evidences of indebtedness or interest, or choses in action.

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3. Although two-party, simultaneous exchanges are possible (and we have done several), more commonly we see three-party, non-simultaneous exchanges using a qualified intermediary (QI). That is, we close the "sale" first with the proceeds going to the QI (not the seller, referred to as the "taxpayer") who holds the proceeds until the taxpayer identifies the replacement property (within 45 days of closing) and closes on the replacement property (within 180 days of closing).
4. The identification letter, which MUST be delivered to a person involved in the exchange unrelated to the taxpayer within 45 days of the closing of the relinquished property, may list up to three potential replacement properties without regard to value or as many properties as you want, so long as the total value of the identified properties does not exceed 200% of the value of the relinquished property. The replacement properties do not need to be under contract at the time they are identified.
5. Any cash received by the taxpayer (boot) will be taxed as if no exchange had occurred. The property received will still result in the deferral of gain to the extent not taxed on the cash, and the basis in the acquired property will be adjusted accordingly.
6. If the mortgage on the replacement property is larger than the mortgage on the relinquished property, the difference will be taxed as though it were boot.
7. Relief from indebtedness (such as a short sale when the lender forgives the unpaid part of the note) also counts as boot and is taxed accordingly.
8. If the relinquished property was acquired using a 1031 exchange then your basis relates back to the previous property causing an even larger gain than the mere purchase price plus capital improvements less depreciation of the current property you want to sell. This increases the benefit of a 1031 exchange.
9. A vacation home can be considered as held for business purposes if it is rented out at least two weeks in each of the two 12-month periods before the exchange and two weeks in each of the two 12-month periods immediately after the exchange and for each 12-month period the taxpayer did not use the home for more than the greater of (a) 14 days or (b) 10% of the number of days it was rented out during the 12-month period.
10. It is possible to transition a property held for investment or business purpose into the taxpayer's principal residence (thus qualifying it for the $250,000 single taxpayer/$500,000 married filing jointly taxpayer exclusion under IRC section 121) if the taxpayer carefully follows rules set forth by the IRS.
11. Multiple property exchanges, reverse exchanges (where you fund an exchange accommodation titleholder to acquire the replacement property before you close on the relinquished property) and improvement or construction exchanges are also possible but beyond the scope of this newsletter.
12. If you attempt to do an exchange that ultimately fails because you do not find an acceptable replacement property or the contract on the replacement property fails to close timely, the worst thing that happens is that you pay the tax (which you would have had to pay anyway if you did not attempt the exchange) and you are out-of-pocket on the costs of setting up the exchange.
13. Don't allow the tax tail to wag the investment dog. If you really do not want to continue to own investment property or are at a stage in life where you need cash or more liquid investments, take the hit, pay the tax, and move on.

If property values continue to rise, more investors and business owners will be looking to move out of one property and into another. An early consultation with a tax or real estate attorney, CPA or other qualified tax advisor before the closing may push the tax ramifications of a standard sale and purchase into the distant future by structuring the transaction as an exchange instead.

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