Farr Law Firm Newsletter
Big City Solutions. Small Town Values.
March 2014 | Issue 5

1031 Exchanges

Part 2 | Beyond the Basics:

Multiple Property Exchanges, Reverse Exchanges and Improvement or Construction Exchanges

In our December 2013 newsletter, we looked at some of the fundamental rules relating to 1031 exchanges. Building on those rules, this newsletter will address three situations which occasionally arise and how they can be dealt with while still taking advantage of the tax-deferral offered by Section 1031 of the Internal Revenue Code.

Multiple property exchanges can involve either multiple relinquished properties or multiple replacement properties. In either case, if structured as a single exchange, the standard timing and identification rules must be strictly adhered to. That is, the 45-day identification period and the 180-day closing on the replacement properties commences on the closing of the first property relinquished. Likewise, all replacement properties must be closed within that 180-day period.

If necessary, the sale of two or more relinquished properties can be split into multiple exchanges. Say you are exchanging two $100,000 properties for one $200,000 property and you have a cooperative seller of the replacement property. When you have a contract to sell the first $100,000 you can exchange that for a 50% tenant-in-common interest in the replacement property, then close on the other half as a separate exchange when you sell the second property. If your seller is not so cooperative, you can do a straight exchange on the first half and a reverse exchange on the second half.

A reverse exchange is what you do when you do not have a buyer for your relinquished property, but you cannot wait to acquire your replacement property. To perform a reverse exchange usually you find a third party to buy the replacement property for you. This will typically be a single-member, single-purpose LLC set up by an attorney, CPA or exchange company which you will fund with cash or a third-party loan sufficient to acquire the replacement property. This is known as an Exchange Accommodation Titleholder (EAT) and the agreement with the EAT will be a Qualified Exchange Accommodation Arrangement (QEAA).

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To be within the IRS's "safe harbor" to qualify the exchange, the 45-day identification period and 180-day closing period starts on the day the EAT closes on the replacement property. Identification is no problem because you already know what property you want to sell. The concern is finding a buyer for your relinquished property, negotiating a deal, getting through the usual inspection period and closing within 180 days of the EAT's acquisition. If the reverse exchange fails, at the end of the 180 days you take ownership of the property (or the LLC) and will either pay the taxes or do another exchange with different replacement property when you find a buyer for your relinquished property.

If you want improvements made to the replacement property (e.g. remodeling an existing building or constructing a new one) and you want the value of those improvement to be included in the value of the replacement property, they can be done by the seller before the exchange occurs or, more likely, by an EAT who holds the property for the construction period. You still must identify the replacement property including the improvements within the 45-day period and acquire the replacement property with improvements within the 180-day period. If the improvements are not complete within the 180-day period, you can still take title to the property, but the construction that occurs after the closing will not count toward the exchange.

Each of these scenarios must be documented and coordinated carefully with advice of experienced professionals. While the costs of these exchanges likely will be more than straight exchanges, in many cases the benefits of deferred taxation will significantly outweigh those costs.

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