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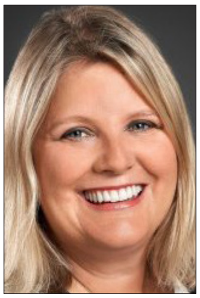
Real Estate Law: This for that: Advising clients in a forward 1031 Exchange



By MICHELLE L. BOUTON

'Tis the season for exchanging gifts, or, in real estate, perhaps the season to exchange one piece of property for another.

Section 1031 Exchanges or "like-kind" exchanges are effective vehicles for investors in real property to defer capital gains tax liability by selling and purchasing real property they would otherwise retain to avoid capital gains tax liability, as long as applicable rules and deadlines are followed.

Section 1031(a) of the Tax Code (the "Code") provides that no gain or loss is recognized on the exchange of real property held for productive use in a trade, business or for investment if exchanged for real property of a "like-kind."

Under the Code, the real property must be of the same nature or character, even if of a different grade or quality. Whether or not real property is improved or unimproved is not material to whether or not it is of "like-kind." Real property in the United States is not of "like-kind" as to real property located outside of the United States. "Like-kind" Exchange treatment only applies to real property held for trade, for business, or investment and does not apply to real property held primarily for sale.

Under the final regulations adopted in 2020, real property includes land and generally anything permanently built on or attached to land. In general, this also includes property characterized as real property under applicable state or local law. In addition, certain intangible property, such as leaseholds or easements, qualifies as real property under Section 1031.

Section 1031(b) of the Code requires that a taxpayer recognize gain to the extent of money and non "like-kind" property received in connection with the sale of real property. It does not permit any losses to be recognized.

After selling a piece of real property (the "relinquished property"), the seller has 45 days after the deed is recorded or possession of the property is transferred to the buyer, whichever is earlier, to identify the replacement property or properties. Both the sale and the purchase must take place within 180 days, close to close. The seller must unambiguously identify the replacement property or properties in writing to a Qualified Intermediary.

Investors can identify up to three properties to purchase in a 1031 Exchange. If an investor wants to identify more than three properties, they can rely on (a) The 200% Rule — if the value of the properties purchased does not exceed 200% of the value of the relinquished property; or (b) The 95% Rule — identifying any number of properties without reference to the sale price of the relinquished property until the investor closes on 95% of the fair market value of the properties identified.

Using a Qualified Intermediary in a 1031 Exchange creates a safe harbor against any claims that the seller received actual or constructive possession of the sales proceeds. In addition, an exchange may be disqualified, and tax benefits lost, if a disqualified intermediary is used. Examples of disqualified intermediaries include attorneys, brokers, accountants, and other advisors who have provided services to the property owner within the past two years. The agreement with the Qualified Intermediary must expressly limit the taxpayer's right to receive, pledge, borrow, or otherwise obtain the benefits of the money or non-like-kind property in the intermediary's possession.

The Qualified Intermediary provides documentation required for a 1031 Exchange, including (1) an exchange agreement between the seller and the Qualified Intermediary; (2) an assignment agreement assigning the seller's interest in the purchase agreement for the relinquished property to the Qualified Intermediary (this is also signed by the buyer to evidence consent); and (3) an assignment agreement assigning the seller's interest in the purchase agreement for the replacement property to the Qualified Intermediary. The Qualified Intermediary never takes title to any of the real property, it just directs delivery of the deed from the seller to the buyer of the relinquished property and the delivery of the deed to the replacement property to the seller.

An investor does not have to use 100% of the sale proceeds to purchase the replacement real property, but if they do not, they will be required to pay capital gains tax on the portion of the sale proceeds not used to purchase the replacement property. Form 8824 must be filed with the property owner's tax return in connection with a 1031 Exchange.

It is important to note that the tax liability is not eliminated under a 1031 Exchange but deferred until the seller sells the real property in question and does not effect a "like-kind" exchange. At that point, the original deferred gain plus any gain realized since the replacement property was purchased will be taxed. It is recommended that clients consult with their tax advisors as well.

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