Take Your Pick

There's More Than One Way To Execute A Sec. 1031 Exchange

Section 1031 exchanges have been around for quite some time. They offer participants a way to dispose of property and subsequently acquire one or more other "like-kind" replacement properties as part of a nonrecognition transaction. The simplest type of exchange is a simultaneous swap of one property for another. Deferred exchanges are more complex but allow for additional flexibility. Here's how they work.

Exchanging Property

Sec. 1031 exchanges are named after Internal Revenue Code Sec. 1031, which allows you to exchange business or investment property (the relinquished property) for business or investment property of a like kind (the replacement property) without recognizing any gain or loss until the disposition or liquidation of the replacement property occurs.

The provision also allows a deferred, or "forward," exchange whereby the relinquished property is transferred before the acquisition of the "replacement property." The replacement property must be identified within 45 days of when the relinquished property is transferred. The replacement property also must be acquired within 180 days of the transfer or by the due date of the applicable tax return (including extensions) for the year in which the relinquished property is transferred, if sooner (the exchange period).

The same time limits apply to "reverse" exchanges. In a reverse exchange, the replacement property is acquired first and then "parked" with an exchange accommodation titleholder (the accommodator) before the relinquished property is transferred.

Unwrapping the Law

In a memo from the Office of Chief Counsel (Memo No. 200836024), the IRS considered a scenario in which a taxpayer structured two separate exchanges. In the first, a reverse exchange, the replacement property was acquired and parked with the accommodator, and the taxpayer identified the relinquished property in a timely manner (within 45 days).

The relinquished property had a much higher value than the replacement property, so the taxpayer planned to engage in a second exchange — a deferred exchange — to defer the gain that remained after the relinquished property was exchanged for the replacement property.

A qualified intermediary (QI) was retained to execute the transfers of the properties in both exchanges. The QI followed all guidelines to ensure the taxpayer wasn't in constructive receipt of any of the exchange funds during the two 180-day exchange periods.

The IRS memo concluded that, as long as the various guidelines are followed, the same relinquished property can be used in both forward and reverse exchanges — even though allowing this structure could result in up to 360 days between the day on which replacement property is parked at the beginning of the reverse exchange and the day the deferred exchange is completed.

It's important to note that a memo from the Office of Chief Counsel is specific to the particular facts that it addresses and has no precedential value. That said, it does provide a guideline for how to structure such a transaction.

Executing an Example

Imagine you decide to take advantage of property values and buy a property in California for $450,000 in January 2014. You park it with an accommodator so you can determine which property you'd like to sell in order to reap the benefits of a reverse exchange.

Within 45 days, you identify a property in New Jersey. In July 2014 — within 180 days of parking the California "replacement" property — you sell the New Jersey "relinquished" property for $1 million, completing the reverse exchange.

You begin executing a deferred exchange within 45 days, identifying additional like-kind replacement properties to buy with the remaining $550,000 of proceeds from the relinquished New Jersey property. And you have 180 days from the close on the New Jersey property to close on one or more identified replacement properties.

So you don't have to close on those properties and complete the deferred exchange until January 2015 — nearly a year after you bought the California property.

Getting Help

To be certain, Sec. 1031 exchanges can be a great way to take advantage of a weak commercial real estate market. But it's not a cakewalk. So work with your tax and real estate advisors to ensure you structure your next deal properly.

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