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Exchanges of investment property continue at a frantic pace bringing up a number of issues

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Despite a recent report by the Mass. Assn. of Realtors that sales of detached single-family homes are softening, sales and exchanges of investment property continue at a frantic pace bringing with it a number of reoccurring issues.

1. Refinancing

a. After the exchange

There is no judicial or legislative reason, nor has the IRS stated a position, why a taxpayer cannot encumber the replacement property after the exchange. The receipt of debt proceeds from a refinancing does not give rise to taxable income.

Refinancing the replacement property contemporaneous with the exchange shouldn't be a problem, since the loan is independent of the exchange. The taxpayer will have to repay the loan when due, and therefore shouldn't be taxed on borrowed money.

b. Before the exchange

Cash received from a pre-exchange refinancing completed as part of an integrated transaction which includes the exchange, may be treated as cash received on disposition of the relinquished prop-

erty. The IRS may assert that the seller has recognized gain because the loan should be viewed as part of the purchase consideration.

The key distinction is whether the taxpayer ever bore the risk of repayment of a debt so as to permit the normal non-realization treatment of refinancing transactions. If the debt "came to rest," i.e., became the taxpayer's liability for more than the time needed to close subsequent parts of an exchange, then the usual non-realization treatment should apply and the existing boot-netting rules should apply to the debt.

A refinancing occurring contemporaneously with the sale of the relinquished property, besides being commercially impracticable, would be subject to a high level of scrutiny especially since it is doubtful that the debt "came to rest."

2. Reverse Exchanges

In a fast paced real estate market, owners of real property often face the prospect of losing the opportunity to acquire a desirable replacement property, when the seller is unwilling to wait while the investor completes the disposition of a relinquished property.

Taxpayers have engaged in parking transactions to facilitate reverse like-kind exchanges. These transactions "park" the replacement property with a qualified intermediary until the taxpayer arranges for the transfer of the relinquished property in a simultaneous or deferred exchange. The taxpayer then transfers the relinquished

property to the qualified intermediary in exchange for the replacement property, and the qualified intermediary then transfers the relinquished property to the buyer. The qualified intermediary should have enough of the benefits and burdens relating to the property so that it will be treated as the owner for federal income tax purposes.

Revenue Procedure 2000-37 describes a safe harbor for reverse exchanges. A reverse exchange will not be challenged if the taxpayer, who will be the ultimate owner of the parked property, satisfies certain requirements, including: (i) the taxpayer enters a written Qualified Exchange Accommodation Arrangement ("QEAA"), and (ii) the taxpayer engages the services of an exchange accommodation titleholder ("EAT").

3. Exchange of Contracts

With the unprecedented appreciation of real estate, many investors have been able to profitably sell their contracts on property without ever taking title to the property. There is very little guidance whether a contract is qualified property. If it is considered real property, then a taxpayer may be able to sell a contract and acquire title to real property to complete the exchange.

If the contract is entered into for the primary purpose of gaining quick appreciation and immediately selling that right to another party for a profit, the contract

would probably be deemed "property held primarily for sale", thereby not qualifying for 1031 exchange treatment. This is a gray area and taxpayers that are considering this type of transaction should seek the guidance of a qualified professional who can assess the potential risk before going forward.

4. Tenant in Common Interests

A popular choice among real estate investors seeking replacement property for their exchange is Tenant-in-Common Ownership (TIC). Under this structure, they will own an undivided fractional interest in an entire property and share in their portion of the net income, tax shelters, and growth. Because TIC opportunities are often "packaged" with management and financing in place, TICs offer superior efficiencies in the identification, acquisition, financing, closing, and operating stages of real estate ownership.

In a hot market, properties move fast and a taxpayer may not be able to close on property it has identified. A ready inventory of tenants in common properties allows individuals to easily identify properties within the 45-day identification period, acquire within the 180 days, or have a "back-up" property in case their preferred real estate falls through.

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