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1031 Exchanges in a Hot Real Estate Market

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Despite a recent report by the Massachusetts Association of Realtors that sales of detached single-family homes are softening (down 10 percent in April and 11 percent in May), sales and exchanges of investment property continue at a frantic pace, bringing with it a number of recurring issues.

Financing

In order to have the flexibility provided by liquidity, many property owners access the equity in their investment property either before, after or simultaneously with a 1031 exchange, raising the issue of whether the refinancing proceeds constitute taxable boot.

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, and there is no valid reason why the taxpayer should wait before encumbering the same. The receipt of debt proceeds from a refinancing does not give rise to taxable income, and the fact that the debt proceeds are from replacement property obtained in a like-kind exchange should not alter this result.

Refinancing the replacement property contemporaneous with the exchange concerns some practitioners, since cash received at the closing can appear at first glance to be moot. This concern, however, is misplaced. Although the loan may fund simultaneously with the exchange, the loan is independent of the exchange and should not be considered money "from such an exchange." It is also significant that the taxpayer will have to repay the loan when due. The taxpayer should not be taxable on bor-

rowed money it will have to repay.

Existing judicial authority indicates that where a pre-exchange refinancing is completed as part of an integrated transaction which includes the exchange, cash received by a taxpayer from a lender will be treated as cash received on disposition of the relinquished property. In such a case, the IRS is likely to assert that the seller has recognized gain because the cash received from the refinancing should be viewed as part of the consideration given by the buyer on acquisition of the property. This principle is sometimes referred to as the "in anticipation of exchange" concept. The IRS attempted formally to include this concept in the Section 1031 regulations by proposing an amendment to Reg. section 1.1031(b)-1(c) in 1990. However, protests from practitioners and the public led the IRS to conclude the proposed rule "could create substantial uncertainty in the tax results of exchanges." The proposal was withdrawn, but the IRS has not formally stated whether it still adheres to the proposition.

The key distinction should be 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. Thus, "true" refinanced debt will be offset either by debt assumed or taken subject to or by cash paid by the taxpayer. From the taxpayer's perspective, this means that refinancings should occur as separate, independent transactions from the exchange.

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."

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 of such property is unwilling or unable to wait while the investor completes the disposition of a relinquished property.

Taxpayers have engaged in a wide variety of transactions, including so-called "parking" or "warehousing" transactions, to facilitate reverse like-kind exchanges. Parking transactions typically are designed to "park" the desired replacement property with a qualified intermediary until such time as the taxpayer arranges for the transfer of the relinquished property to the ultimate buyer in a simultaneous or deferred exchange. Once such a transfer is arranged, the taxpayer 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 ultimate buyer. In other situations, a qualified intermediary may acquire the desired replacement property on behalf of the taxpayer and immediately exchange such property with the taxpayer for the relinquished property, thereafter holding the relinquished property until the taxpayer arranges for a transfer of such property to the ultimate buyer. In parking arrangements, taxpayers attempt to arrange the transaction so that the qualified intermediary has enough of the benefits and burdens relating to the property so that the qualified intermediary will be treated as the owner for federal income tax purposes.

Revenue Procedure 2000-37 describes a safe harbor for reverse exchanges if certain requirements are met. It provides that a reverse exchange will not be challenged if the

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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").

Exchange of Contracts

With the unprecedented appreciation of real estate, many investors have been able to profitably sell their contracts on property under construction or desirable resale properties without ever taking title to the property. Is a contract qualified property for 1031 exchanges? There is very little guidance in this area. It is not clear whether a contract is considered a real property interest or personal property interest as it

applies to 1031 exchanges. 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 considering this type of transaction should seek the guidance of a qualified professional who can assess the potential risk before going forward.

Tenant in Common Interests

A popular choice among real estate investors seeking replacement property for their exchange is Tenant-in-Common

Ownership (TIC), also known as fractional ownership. Under this co-ownership structure, they will own an undivided fractional interest in an entire property and share in your 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. ■