Complex Issues Concerning 1031 Tax-Deferred Exchanges

Since 1921, the rules for qualifying and completing 1031 exchanges have gradually broadened and become less restrictive. Even so, there are do's and don'ts as well as several gray areas of which taxpayers should be aware.

Holding periods

There are no standard or specific holding periods that a taxpayer must abide by (the only exception is *Related parties*, discussed below). Holding periods are, therefore, determined on a case-by-case basis with regard to the taxpayer's intentions based in part on: their reasons for acquiring, holding, and disposing of the property; the taxpayer's primary occupation; previous 1031 exchange activity; and use of property. Generally, the longer the holding period the better. However, a taxpayer who is disqualified from utilizing the benefits of Section 1031 would not then qualify merely because of a long holding period. What the Code, the courts, and the IRS want to prevent are taxpayers holding property primarily for sale from deferring their taxes utilizing Section 1031 (e.g., a car dealer or a builder of residential subdivisions).

Related parties

Related parties may do exchanges with each other; however, there is a mandatory 24-month holding period for both related parties. Related parties can be business, familial, or ancestral. Should either party dispose of their newly acquired property in less than the 24-month required holding period, both parties' exchanges will be disallowed. The current rules are complex and restrictive, and all potential related party exchangers must seek their own tax counsel.

Different entities

Generally, to qualify for Section 1031 the same entity which transferred the relinquished property must acquire the replacement property.

Already owned property

The like kind requirement will not have been met if the taxpayer attempts to transfer the gain from the relinquished property into property the taxpayer already owns.

Refinance

It is generally accepted that the taxpayer can receive equity from the replacement property through the placement of a new loan (refinance). However, the taxpayer must not refinance "in anticipation" of an exchange by placing a loan on the

relinquished property once the taxpayer has taken steps to dispose of such property unless the taxpayer: 1) uses those proceeds to acquire or improve the replacement property, and 2) has no actual or constructive receipt of such proceeds.

Dissolution of a partnership

The Code is clear—partnership interests do not qualify for Section 1031 tax deferral. Yet taxpayers' advisors routinely recommend the following strategy:

1. Dissolve partnership.
2. Create new entity (tenancy-in-common).
3. Distribute pro-rata share to individuals (previously partners).
4. Exchange individual tenancy-in-common interests at will.

Two fundamental problems arise from this advice:

1. The Code requires that property must be "held for productive use in a trade or business or investment." This implies that there is a holding period, although, as discussed above, the holding period is uncertain.

2. If the new structure was construed by the IRS as merely a strategy or series of steps to avoid the exclusion pertaining to partnership interests, the exchange would be disallowed.

Terminating an exchange and receiving the net proceeds

Occasionally, a taxpayer wants or needs to terminate an exchange after the net proceeds have been transferred to the Qualified Intermediary. By the IRS Regulations and a substantive (valid) exchange agreement, the taxpayer may receive the net proceeds:

1. After the 45-day identification period if there are no properties identified, or
2. After the 45-day identification period but before the end of the 180-day exchange period if all identified properties have been acquired, or
3. After the 180-day exchange period.