

Expert Answers to Tough 1031 Questions

The application of Section 1031 has continued to evolve since 1921. With favorable modifications to the Code by Congress and rulings by the IRS and the courts, taxpayers have far more solutions available today than at any other time. As a result, our experts at LandAmerica 1031 Exchange Services (LandAmerica 1031) can now provide you more guidance in structuring your exchanges and provide more definitive answers to your questions than ever before. Some of the questions taxpayers frequently ask are listed below. Please feel free to call one of our specialists should you have additional questions. We also strongly recommend that you consult with your personal tax advisor.

Is the role of the Qualified Intermediary (QI) really necessary?

As QI, LandAmerica 1031 provides many necessary and helpful functions during the exchange. If our role were narrowed down to the absolute necessary elements they would number only two:

1. Provide the taxpayer with the required paperwork (Exchange Agreement for simultaneous, deferred, and to-be-built exchanges, and Qualified Exchange Accommodation Agreement for reverse and reverse construction exchanges) to establish the taxpayer's intent to do an exchange, to create the structure of an exchange, and to make sure the end result complies with the laws and rulings.
2. Act as the accommodator and have all proceeds redirected to LandAmerica 1031 to protect the taxpayer from actual (direct) or constructive (indirect) receipt of those funds, either of which would invalidate the exchange.

Other important functions are our ability to provide 100% security for all funds we hold, maintain updated documents to reflect changes in the law, answer complex questions, provide creative solutions, be available on short notice to produce the necessary documents, keep our customers informed on the status of various time frames, and generally provide any and all customer services when needed.

Is a QI necessary in a simultaneous exchange where all deeds and proceeds are transferred within minutes of each other?

What is needed in all exchange structures (except a two-party direct swap) is for a party to the transaction, other than the taxpayer, to receive the cash proceeds from the transfer of the taxpayer's relinquished property. Before the advent of QIs, this person was either the buyer of the taxpayer's relinquished property or the seller of the replacement property. This person was called the "accommodating grantor" or, simply, the "accommodator." Today, the accommodator is an additional

party in the transaction referred to as a Qualified Intermediary. LandAmerica 1031 Exchange Services is such a Qualified Intermediary.

Why has the government allowed tax-deferred exchanges to exist since 1921?

A widely held opinion is that the government makes more money with tax deferral than without it. Tax deferral is an economic stimulus which encourages property sales and purchases. These sales and purchases directly provide millions of jobs. In addition, these millions of people employ others through their spending. The end result is that the government collects more income tax. The absence of tax deferral would cause most investors to hold on to their properties and not sell them. No real estate sales, no related employment. No employment, no spending and no income tax collected. Congress discovered soon after the implementation of our income tax code in 1913 that various types of tax deferrals were necessary exceptions.

Can related parties do exchanges with each other?

Yes. It is a complex issue, however, that deserves further explanation and may change with future rulings. If this issue is important to you, please contact a LandAmerica 1031 office for more information on related party exchanges and contact a knowledgeable tax advisor before proceeding.

Is an exchange sometimes not appropriate?

Yes. An exchange is inappropriate when:

1. The taxpayer has a capital loss.
2. The taxpayer does not want like kind property.
3. The taxpayer wants a higher depreciable basis in the replacement property.
4. The taxpayer wants a substantial amount of cash (classified as “boot”).
Receiving boot is generally a taxable event but does not necessarily disallow the exchange. However, once the amount of tax on the boot received equals or exceeds the amount of tax on the realized gains, there is no advantage to the exchange.

Can real estate be exchanged for anything other than real estate?

No. However, all real estate can be exchanged for all other real estate except:

1. Real estate held as a primary residence or for personal use.
2. Real estate held primarily for sale or as inventory.
3. U.S. real estate for foreign real estate, or vice versa.
4. Real estate not identified or acquired within the time frames provided for in the Code.
5. Real estate exchanged between related parties who do not meet the strict rules regarding such exchanges.

Do second homes qualify for exchanges?

Yes, as long as the primary purpose for the second home is not for personal use. For example, let's say the taxpayer personally uses the property one or two weeks a year but then the property is rented much of the rest of the year. Excluding the percentage of the year the property is used personally, this property could, in fact, be exchanged. How much personal use will disqualify the property is uncertain. If you are contemplating such an exchange, we strongly urge you to contact a knowledgeable tax advisor before proceeding.

Do real property leases qualify for Section 1031 exchanges?

Yes. The requirement is that leases must have 30 years remaining at the time of the exchange to qualify as like kind property to real estate. Unexercised options to renew can be included in the 30-year calculation.

Is the taxpayer required to acquire the replacement property with the same name as was on the relinquished property?

Generally, yes. This was firmly established in *Starker vs. U.S.* 602 F.2d 1341 (1979). In that case T.J. Starker had one replacement property deeded to his daughter and another acquired by way of an option to purchase. An option is personal property and not like kind to real estate. Both properties were disallowed as not being like kind property. The only exceptions involve single-member limited liability corporations and grantor trusts.

Can a taxpayer do an exchange if the lender is given the deed in lieu of foreclosure?

Theoretically, yes. It is still likely that there is a taxable capital gain and depreciation recapture even if there is no remaining equity. There are several complexities to consider:

1. Can the lender somehow prevent an exchange from occurring?
2. Will the investor have other moneys in which to acquire replacement property?
3. Will the IRS consider this to be a short sale?

Are partnerships allowed to do exchanges?

Yes. All tax-paying entities are entitled to the benefits of Section 1031.

Can the individual partners do an exchange?

No. The Code is clear that "This subsection shall not apply to any exchange of...interests in a partnership." IRC (Section 1031 (a)(2)(D)). There are no definitive rulings that sanction the use of creative structures that circumvent the Code. If you are contemplating such a type of structure, we strongly urge you to seek the advice of a knowledgeable tax advisor before proceeding.

What are the tax considerations if the taxpayer carries financing for the buyer?

An exchange can be structured so the taxpayer either receives the note and incurs a tax liability or has LandAmerica 1031 receive the note from the buyer with no tax liability to the taxpayer. Below is an overview of the various structures regarding notes. Because of the complexities in these structures, you must obtain the advice of a knowledgeable tax advisor before deciding on which structure to use.

1. Taxpayer receives note. The note is considered boot and is taxable. The taxpayer may elect to pay the gain on the note in his or her next tax filing or not to make such election and to receive Installment Sale treatment.
2. Taxpayer has note (and all payments) made payable to LandAmerica 1031. LandAmerica 1031 holds the note during the exchange period while the taxpayer attempts to use the note as consideration for the replacement property. If successful, the note is passed through to the replacement property owner and the taxpayer has no tax liability on the note.
3. Taxpayer has note (and all payments) made payable to LandAmerica 1031. LandAmerica 1031 holds the note during the exchange period while the taxpayer attempts to use the note as consideration for the replacement property. If not successful, the note is received by the taxpayer at the end of the exchange and considered boot. The taxpayer may elect to pay the gain on the note in his or her next tax filing or not to make such election and to receive Installment Sale treatment.
4. Taxpayer has note (and all payments) made payable to LandAmerica 1031. Taxpayer purchases the note from LandAmerica 1031. There should not be a tax on the note as cash boot added offsets cash boot received (the note).
5. Taxpayer has note (and all payments) made payable to LandAmerica 1031. Taxpayer attempts to find a third-party buyer for the note while it is being held by LandAmerica 1031. If successful, the note is replaced with cash and the cash is added to the proceeds held by LandAmerica 1031 and used as consideration for the replacement property. If the note was sold at a discount, there may be taxes due on this discount.