White Paper

Section 1031
Tax Deferred Exchanges

by Mary B. Foster

What Is a Tax Deferred Exchange? 1

Structuring an Exchange 2

Beyond the Typical Exchange 4

Reverse Exchanges 5

Other Exchange Requirements 6

Conclusion 8

About the Author 8

Thomson West resources for understanding
Tax Deferred Exchanges 9, 10

THOMSON
WEST ™

"A tax deferred exchange is an invaluable tool in a business's overall tax strategy."

Exchangor: The individual or business owning the assets being exchanged.

Relinquished Property: The property being sold in the exchange.

Replacement Property: The property being purchased in the exchange.

Intermediary: The unrelated middleman in the exchange.

An exchange can result in tremendous savings because federal tax rates on the gain from the sale of business assets range from 15 percent for sole proprietors up to 35 percent for publicly held corporations. In addition, many states also tax gains from the sale of property at rates that can exceed 9 percent in the high-tax states. Fortunately, a properly structured exchange defers these taxes indefinitely, and these tax dollars saved by the exchange can be reinvested in new real or personal business property.

Each business should understand not only basic exchanges, but also the many other areas where an exchange can be used to save substantial tax dollars. For example, while exchanges have traditionally been associated with real estate, they are used today for all types of tangible and intangible business assets. In fact, many of today's largest volume exchanges are of items such as airplanes, car or truck fleets, and heavy equipment. Businesses such as television stations, restaurants and dental practices can also be exchanged, as well as investment assets such as artwork and unimproved land.

"In order for an exchange to be completely tax deferred, the replacement property must have a fair market value equal to or greater than the relinquished property and all of the Exchangor's equity must be used in acquiring the replacement property."

What Is a Tax Deferred Exchange?

A tax deferred exchange is simply a method of trading one property (the relinquished property) for another "like-kind" property (the replacement property), without paying any federal income taxes (and usually state income taxes) on the transaction. The tax on the transaction is deferred until some time in the future, usually when the newly acquired replacement property is sold.

Tax deferred exchanges are authorized by Section 1031 of the Internal Revenue Code. The IRS has issued taxpayer friendly guidelines that make a typical exchange relatively easy and inexpensive. A sale and a reinvestment in a replacement property are converted into an exchange by means of an exchange agreement and the services of a qualified intermediary – an unrelated fourth party who helps to ensure that the exchange is structured properly.

In order for an exchange to be completely tax deferred, the replacement property must have a fair market value equal to, or greater than, the relinquished property, and all of the Exchangor's equity must be used in acquiring the replacement property. This is known as trading up or equal in value and equity.

Structuring an Exchange

Let's look at the structure of a typical exchange. Suppose that ABC Corp. wants to move its offices to a new office building. The old office building can be sold for $3,000,000. Development Company has built the new office building and will sell it for $5,000,000. ABC Corp. would like to use the equity from the old office building and acquire the new office building. ABC Corp. will obtain financing for the $2,000,000 trade up in value between the old office building and the new office building. Buyer LLC would like to buy the old office building as an investment and has made an all-cash offer to ABC Corp.

Party	Has	Wants
ABC Corp. (Exchangor)	Old Office Building FMV $3,000,000	New Office Building FMV $5,000,000
Buyer LLC	$3,000,000 Cash	Old Office Building
Development Company	New Office Building	$5,000,000
Intermediary	N/A	N/A

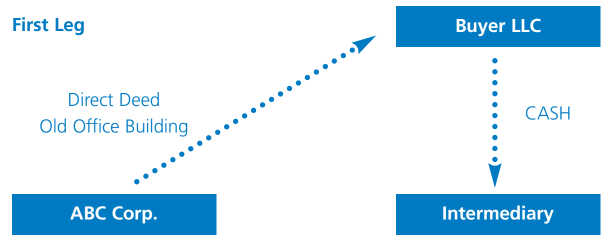
With the intermediary acting as the middleman, each of the parties will give up what it has and acquire what it wants. When the exchange is complete, ABC Corp. will own the new office building, Buyer LLC will own the old office building and Development Company will have cash. ABC Corp. will have traded up in value and reinvested all of its equity in the new office building, thus accomplishing its goal of a totally tax deferred exchange.

Time Limits

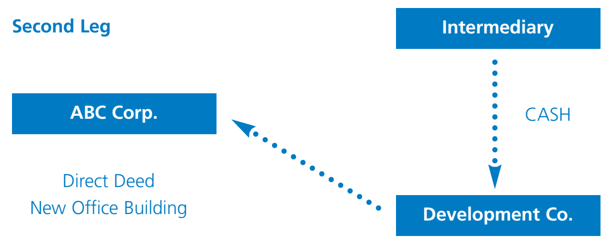
Fortunately, exchanges are not required to be closed simultaneously. However, the Exchangor only has limited time periods after transferring the relinquished property to identify and acquire the replacement property. Thus, if ABC Corp. were to sell the old office building prior to selecting a new office building, ABC Corp. would have 45 days from the date of the transfer of the old office building to locate and identify the new office building. To complete the exchange, ABC Corp. must acquire the new office building within 180 days of the transfer of the old office building.

"The 45 day written identification is the most difficult requirement to meet in an exchange."

The following diagram shows the steps in a typical exchange:



ABC Corp. must then identify the new office building in no more than 45 days and must acquire it in no more than 180 days.



More on the Identification Requirement

ABC Corp's identification must be in writing and delivered to a party to the exchange, usually the intermediary, by midnight of the 45th day. The property must be unambiguously described, such as by street address or legal description for real property. There is no requirement that ABC Corp. have entered into a written purchase agreement with Development Company by the 45th day.

In practice, the 45 day written identification is the most difficult requirement to meet in an exchange. Forty-five days is a short time to find suitable properties. Often, the identified properties fall through because the seller will not sell, or some other contingency is not met. Therefore, ABC Corp. would be wise to identify alternative properties. The IRS Regulations do allow for alternative identifications, as follows:

- ABC Corp. may identify up to three properties of any fair market value; or
- If ABC Corp. wants to identify more than three properties, the total fair market value of all these identified properties cannot not exceed 200% of the value of the old office building.

Thus, ABC Corp. could identify (1) three properties of any value, or (2) up to $6,000,000 of any number of properties (200% of $3,000,000, the value of the old office building).

"... there are also many creative structuring techniques that can be used in atypical situations that many businesses might not consider."

Documentation

The exchange must be properly documented in accordance with IRS regulations. These regulations allow the old building and the new building to be transferred directly between the parties (without actually transferring either property to the intermediary), therefore reducing the costs of recording fees and transfer taxes.

Beyond the Typical Exchange

While a typical exchange is easy to structure and accomplish, there are also many creative structuring techniques that can be used in atypical situations that many businesses might not consider. For example:

- An exchange can be structured with the Exchangor constructing the new building with exchange proceeds, thus eliminating the third party development costs;
- A replacement property can be renovated with exchange proceeds;
- Multiple properties can be exchanged into a larger property, or conversely, one property can be exchanged into several smaller properties; or
- Multiple investors can acquire one replacement property in a tenancy in common arrangement.

There are many other possibilities for the business that thinks "outside the box" to acquire the right properties in atypical situations while still deferring the taxes. One major planning opportunity is the reverse exchange, which is discussed next.

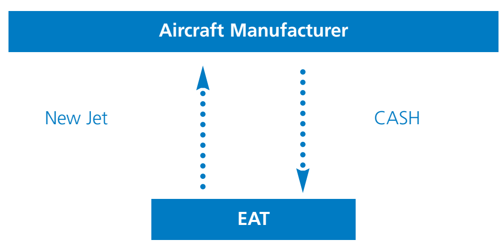
Reverse Exchanges

The previous example displays a "forward" exchange in which the relinquished property is sold first, followed by the acquisition of the replacement property. Exchanges can also be done in the reverse order. For example, suppose ABC Corp. wants to exchange its old corporate jet for a new jet. The new jet is ready to fly and ABC must acquire it from the manufacturer. However, no buyer has been found yet for the old jet. The IRS has created a set of guidelines that could be used to structure a "reverse" jet exchange. Like the forward exchange, the reverse exchange must be completed in no more than 180 days.

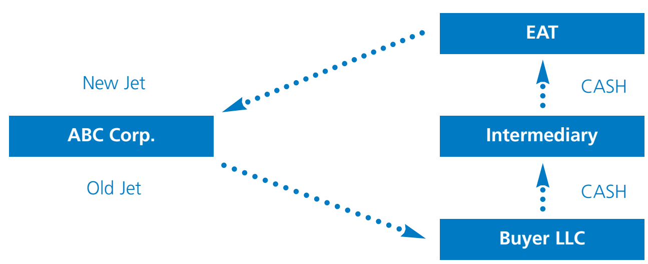
EAT: The accommodating party who holds title to the one of the properties (the EAT is often related to the Intermediary).

Reverse Example:

The "exchange accommodation titleholder" or EAT acquires the new jet from Aircraft Manufacturer with a cash loan from ABC Corp. The new jet is leased by the EAT to ABC Corp. while ABC Corp. finds a buyer for the old jet.



No more than 180 days later, when a buyer is found for the old jet, the EAT transfers the new jet to the ABC Corp. in exchange for the old jet. Proceeds from the sale of the old jet are used to repay ABC Corp.'s loan for the new jet.



Beyond the Typical Reverse Exchange

There are many variations on a reverse exchange:

- Multiple relinquished properties or replacement properties may be sold and acquired at different times in combination reverse and forward exchanges;
- Two or more parties can exchange into the same property, such as parties exchanging into tenant-in-common interests in real property or aircraft;
- A related party can acquire the relinquished property or sell the replacement property in certain circumstances; or
- The reverse exchange may extend beyond the safe harbor of 180 days.

All of these structures require careful planning and analysis of the relevant caselaw and IRS guidance. Many are in the gray areas of tax law and require some assumption of tax risk by the Exchangor.

Other Exchange Requirements

What Properties Do Not Qualify

In general, all business or investment property, both real and personal, can qualify for tax deferred treatment. However, some types of property are specifically excluded, such as: inventory or other property held primarily for sale ("dealer" property); stocks, bonds, and notes, including REIT shares; and certificates of trust or beneficial interests.

> "A co-ownership arrangement structured as tenancy in common (an undivided interest in the property) is not excluded from Section 1031."

Interests in a co-ownership arrangement structured as a partnership or a multi-member LLC are also excluded from Section 1031. For example, a person cannot separately exchange into or out of property co-owned with others in an LLC or partnership (the parties can, however, do an exchange together as the LLC or partnership). A co-ownership arrangement structured as tenancy in common (an undivided interest in the property) is not excluded from Section 1031. However, the tenancy in common must be carefully structured to avoid recharacterization as a partnership for federal tax purposes. This is not a black-and-white area of tax law, but a "gray area" that requires careful analysis of the applicable caselaw and IRS guidance.

"There are several techniques that may work to convert a personal residence or vacation home into property that is eligible for Section 1031 treatment ..."

Business or Investment Intent

Both the relinquished property and the replacement property must be "held for productive use in a trade or business or for investment." This means the Exchangor cannot exchange into or out of the his or her own personal residence, or property held for resale as a dealer. Vacation homes may qualify if they are rented out by the Exchangor to unrelated persons, or held primarily for investment rather than personal use. There are several techniques that may work to convert a personal residence or vacation home into property that is eligible for Section 1031 treatment, as well as IRS guidance on the exchanges of property that is used both as a residence and for business use, such as a farm or ranch.

Like-Kind Requirement

Replacement property acquired in an exchange must be "like-kind" to the relinquished property. All real property is generally like-kind, regardless of whether it is bare land or land with a building. Commercial property is like-kind to residential property. Real property, however, is not like-kind to personal property, and a building cannot be exchanged for an airplane. Further, the like-kind standard for personal property exchanges is much narrower than that for real property. For example, a car is not like-kind to a truck.

No Receipt of the Exchange Proceeds

"Any exchange proceeds actually received or held by the Exchangor are taxable, despite the fact that the Exchangor later reinvests them in the replacement property."

Any exchange proceeds actually received or held by the Exchangor are taxable, despite the fact that the Exchangor later reinvests them in the replacement property. Even if the Exchangor does not *actually* receive the exchange proceeds, they will be taxed if the Exchangor is considered to have "constructively" received them. The IRS Regulations provide rules on what constitutes constructive receipt under Section 1031, and generally require that the exchange proceeds be held by a third party out of the control of the Exchangor until the end of the exchange. This third party can be a qualified intermediary, or an independent escrow or trust. None of these parties can be related to the Exchangor. Therefore, the Exchangor should be sure that the party holding the exchange proceeds is keeping them in a safe place and in a liquid investment so the proceeds are available when the replacement property is ready to close. The Exchangor may receive the interest earned on the exchange funds without impacting the exchange, provided the interest is not actually paid to the Exchangor until the completion of the exchange.

Conclusion

Tax deferred exchanges can dramatically reduce taxes. The basic exchange is easy to structure and is an invaluable tool for a business that buys and sells capital assets. There are also many more advanced and creative ways to structure exchanges outside of the typical exchange. Often these creative exchanges are in the "gray area" of tax law and require careful analysis and advice. *Tax Free Exchanges Under §1031* is the best source of information on both basic and advanced exchange structures and is often described as the bible of Section 1031. It sits on the desk of thousands of attorneys, CPAs and other professionals interested in Section 1031.

About the Author

Mary B. Foster, president of 1031 Services, Inc., has been involved in thousands of exchanges as attorney and intermediary for large corporate clients as well as small and individual investors. She is co-chairperson of and has participated as a speaker in an annual, two-day, national seminar on advanced issues in like-kind exchanges since 1996. Additional information is available about the seminar at www.1031services.com. In addition, she frequently lectures before CPAs and attorneys, and other professional groups and investors on the topic of tax deferred exchanges. Ms. Foster is co-author of *Tax Free Exchanges Under §1031*, published by Thomson West. She is a member of the Tax Sections of the American Bar Association (ABA) and Washington State Bar Association. She is the former subcommittee Chairperson on the ABA Real Estate Committee for issues on Like-Kind Exchanges. She is also a board member and president elect of the Federation of Exchange Accommodators (FEA), and active in federal legislative and administrative efforts related to IRC §1031 on behalf of the ABA and the FEA. She is a contributing author to Matthew Bender's *Federal Tax Service*, the *Journal of Passthrough Entities*, *New York University Institute of Federal Taxation*, *Business Law Journal*, the *Journal of Accountancy*, *The Journal of Real Estate Taxation*, *Tax Management Memorandum*, and *The Practical Tax Lawyer*.

Ms. Foster received her B.A. from the University of Michigan, with honors in economics (1981) and her J.D. from Boalt Hall, University of California, Berkeley, where she was a member of Order of the Coif (1984). Prior to joining the company, Ms. Foster practiced tax law for 12 years with a Seattle law firm.

WEST Key AUTHORS

Thomson West resources for understanding tax deferred exchanges

Online Resources

For assistance in understanding and complying with the many issues surrounding tax deferred exchanges, please consult the following resources.

Westlaw provides easy searching of information and tools relating to this topic. You can:

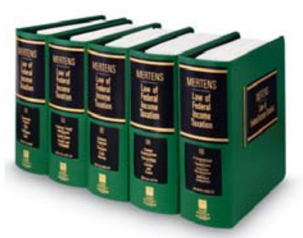
- Review the federal regulatory treatment of tax deferred exchanges with the help of RegulationsPlus™, a feature on Westlaw that provides access to a fully annotated and indexed Code of Federal Regulations (CFR).
- Real Property Practitioner on Westlaw® gives you easy access to real estate law forms, practice guides, and checklists, all in one place, which ensure you have the right information and take the right cases. For an additional charge, you also can have easy access to state and federal statutes and regulations, including *Code of Federal Regulations*, as well as public records such as state tax assessor and transaction records.
- Search all federal appellate and tax court cases that involve tax deferred exchanges and compare the facts and issues in them with the circumstances presented in your client's situation.
- View the most recent corporate disclosures from your peers and competitors, and be alerted to new SEC filings with LIVEDGAR® from GSI®.

Thomson West resources for understanding tax deferred exchanges

Print Resources

- **Tax Free Exchanges Under Sec. 1031** by Mary B. Foster and Jeremiah M. Long, provides a guide for attorneys or accountants who are advising clients in investment real estate. The book answers many of the critical questions in the field of exchanges, such as how seller-financed transactions are dealt with in exchanges without the taxpayer receiving boot subject to tax, how are reverse exchanges structured, what problems arise from reverse exchanges, and when are Section 761A elections appropriate.

- **Real Estate Transactions – Structure and Analysis with Forms** by Alvin L. Arnold offers expert guidance, ready-to-use forms, and checklists for negotiating and documenting profit-making real estate deals. It focuses on such topics as: negotiating the purchase and sale of real estate, commercial leases, sales contracts and real estate exchanges, joint ventures and participating debt, real estate securitization, mortgage loan commitments and participating/convertible loans, real estate evaluation, and more.



- **Merten's Treatise on the Law of Federal Income Taxation** provides in-depth analysis of the law of federal income taxation, explaining the intent of Congress in drafting the Code, what the Code means and how the Internal Revenue Service has been interpreting it.

For more information about Thomson West resources, call 1-800-248-2449 or visit west.thomson.com/corporate.

Thomson West is a world-leading provider of legal, news and public records information serving business and compliance professionals. Thomson West is a business within the Thomson Corporation (NYSE: TOC; TSX: TOC) and was formed when West Publishing and Thomson Legal Publishing merged in June 1996.

For more information about Thomson West and Westlaw,
call 1-800-248-2449 or visit west.thomson.com/corporate.

THOMSON WEST™