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# Pitfalls of Tax-Deferred Exchanges in Real Estate

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BOSTON — May I be so bold to presume that the overwhelming majority of us prefer to contribute to the charities of our choice. We wish Mr. Warren Buffet all the best, but do we want to participate in his quest to reduce the federal deficit with his Billionaire's Tax? Probably not.

Photo: Derek Szabo

One way for an owner of income producing real estate to reduce her personal tax burden is to take advantage of Section 1031 of the Internal Revenue Code. Yes, the rules of compliance are complex and

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tricky, and the failure to meticulously adhere to them will not only result in the recognition of capital gains, but interest and penalties resulting in an involuntary contribution to a charity not of one's choosing.

But the rewards for playing by the tax rules may not only defer the taxable gain on a sale of real estate, it could be a permanent deferral if replacement property that is the result of one or more successful 1031 exchanges is owned by the taxpayer's estate on her death. Her heirs will reap the benefit of a step-up in tax basis to the current value of the real estate and avoid the capital gain tax altogether.

Although the rules governing 1031 exchanges are vast, here are some commonly experienced pitfalls that cost taxpayers dearly, particularly when they try to go it alone without the proper counsel of a tax professional.

**1.** Real estate that qualifies for 1031 treatment may be either improved or vacant land and must be held for investment or for use in a trade or business. Real estate developers can qualify but they have a harder time proving that the real estate that they want to exchange is held for investment or in a trade or business. For example, land purchased to be subdivided is used in a trade or business but is considered inventory and does not qualify as a capital asset, and, therefore not eligible under Section 1031.

"Avoid the tax return due-date trap!"

GARY M. MARKOFF ESQ.

**2.** There are identification and time line requirements that are strictly enforced. The taxpayer should be looking for the replacement property long before any agreement to sell the relinquished property is made. At the latest, the replacement property must be identified in writing within 45 days and purchased within 180 days from the sale of the relinquished property. Identification is usually done in the form of a letter to a qualified intermediary. The taxpayer may identify as many as three alternate properties of any value. If more than three are identified, the value of the identified properties cannot exceed 200 percent of the value of the relinquished property unless at least 95 percent in value of the identified properties are acquired. Avoid this 200 percent trap by avoiding identifying more than three properties. Of course, if none of the three properties identified are acquired within the 180 day period, there can be no qualified 1031 exchange. Another trap is if the replacement property is not acquired before the current year's federal income tax return is due (including extension) prior to the expiration of the 180-day period. The taxpayer, therefore, may need to extend the tax return in order to take advantage of the full 180 period. Avoid the tax return due-

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# Tax-Deferred Exchanges

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date trap! Extend the return if more time is needed to close on the replacement property.

**3.** The major underlying premise of every 1031 exchange is that there is no constructive receipt of the sale proceeds of the relinquished property. Actual possession of the cash is not required to demonstrate constructive receipt. Receipt of the sales proceeds by the seller's attorney or accountant is considered constructive receipt by the taxpayer. National title insurance companies have subsidiaries that act as qualified intermediaries. They make convenient and competent QI's because they are intimately familiar with the workings of a real estate transaction and also available to insure title to the replacement property. Avoid constructive receipt and use a qualified intermediary!

**4.** Can a taxpayer undertake a 1031 exchange with a related party? Surprisingly yes, but the relinquished and replacement properties must be held by the related properties for at least two years. Beware of the two-year trap!

**5.** To defer all of the taxable gain in a 1031 exchange the following rules should be followed:

**a.** The replacement property value should not be less than the value of the relinquished property.

**b.** The net proceeds from the sale of the relinquished property should be used to purchase the replacement property.

**c.** The mortgage balance on the relinquished property should not be less than the mortgage on the replacement property.

If these rules are ignored, so-called "boot" will be taxed and not all of the gain will be deferred. Avoid Boot!

The last pitfall is to avoid going it alone. Sophisticated tax and real estate counsel is needed to properly structure and implement a tax deferred exchange so that there are no surprises when either the tax return is prepared and filed, or the return is chosen for audit by the IRS.

Safe exchanging! ■

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