

# The Return Of 1031 Exchanges

## *Current trends and critical issues in the exchange business.*

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Between 2002 and 2007, real estate investors and developers built tremendous wealth and preserved significant equity by using tax-deferred exchanges under Section 1031 of the IRS Code. Exchanges became commonplace in most transactional real estate planning and resulted in exceptional tax-mitigation opportunities. During the past 3 years of economic downturn, however, exchanges were used less frequently for preserving equity from the appreciation of real estate — mainly due to offsetting losses from other transactions or a general erosion of equity altogether. More often, over the past few years taxpayers used exchanges as a strategy for deferring potential tax liability from short sales and foreclosures.

Over the previous nine months, it has become readily apparent that taxpayers are again relying on exchanges due to real estate assets being sold at a gain. Because it has been a few years since many developers and investors last performed tax-deferred exchanges, it is prudent to revisit key concepts and understand new exchange developments.

### EXCHANGE TRENDS

Starting in August 2010, the volume of exchange transactions began to increase significantly. This trend started with developers and investors selling singular assets and asset portfolios to large REITs and private equity funds who were looking to purchase assets with cash. Class A and B multifamily assets and single-tenant NNN assets backed by national credit tenants were their typical targets. These purchases fueled the start of new construction exchanges by many of the selling developers, especially in the single-tenant NNN industry. The exchange trend has since spread to larger, more institutional assets in the office and retail sector. As of late, grocery-anchored retail centers have also seemed to be at the center of exchange activity. The common

underlying characteristic of the assets being sold in these exchanges has been the stability of the asset, often stemming from strong credit tenants.

Further influencing this growing exchange trend has been the return of debt to the marketplace. Developers and investors appear to have found committed lending sources they can finally rely on, including institutional options such as life companies, CMBS, private equity/debt sources, and retail debt. However, recent U.S. credit rating concerns and debt ceiling uncertainty, increased international unrest, and turmoil on Wall Street caused by extreme volatility in the stock market has caused both CMBS pricing to be rebuked by the market and retail debt lenders to pull back on commercial lending.

### CONSIDER BOTH TAX AND NON-TAX EXCHANGE BENEFITS

Most taxpayers recognize the tax-deferral element of 1031 as the most significant benefit of using exchanges. Essentially, capital gains tax at both the federal and state level, as well as depreciation recapture, may be deferred through a properly executed exchange. This deferral can be an indefinite benefit, as the taxpayer does not recognize the taxable gain until the property is sold without the use of an exchange. Should the taxpayer combine an exchange strategy within their estate planning structure, it is possible to leave exchange assets to heirs and essentially defer the taxable gain indefinitely. The assets will, of course, be subject to inheritance tax rules.

A significant byproduct of the tax deferral is the ability to preserve equity within the transaction. This preserved equity, once reinvested, allows a taxpayer to build wealth. Greater cash equity allows the taxpayer to: a) purchase a more expensive replacement asset; b) buy an asset using less debt (which may improve cash flow); or c) qualify for greater debt

financing for the acquisition of a replacement asset due to the increased amount of equity available for the purchase.

In addition to tax deferral, exchanges allow a taxpayer to benefit from any combination of the following:

- diversify or consolidate one's real estate portfolio among asset types (multifamily, office, retail, etc.);
- diversify or consolidate the geographic focus of one's real estate investments;
- sell less productive assets and replace them with those that have greater return potential; and/or
- unwind partnership structures to allow the partners to invest separately from one another.

These are but a few of the numerous non-tax benefits available through the 1031 exchange process.

### BECOME FAMILIAR WITH VARIOUS EXCHANGE ALTERNATIVES

Most taxpayers are familiar with the most common exchange transaction, the forward-delayed exchange. In these exchanges a taxpayer sells their relinquished property to a third-party purchaser, uses a Qualified Intermediary (QI) to hold their exchange proceeds, and eventually acquires replacement property from a different third-party seller. Many taxpayers are not aware of other exchange structures that have been used for years by savvy real estate investors and developers.

These other strategies include reverse exchanges, whereby replacement property is acquired prior to the sale of the relinquished property. In these transactions, the taxpayer must rely not only on the assistance of a QI, but must also engage an Accommodating Titleholder (AT) to take title to the targeted replacement property. The AT, which is often an LLC that is owned by an affiliate of

the QI, will hold replacement property on the behalf of a taxpayer until the taxpayer has sold the relinquished property. reverse exchanges work well when the taxpayer must purchase the replacement property before the relinquished property can be sold.

Additionally, taxpayers may use a construction exchange in order to build ideal replacement property or use leasehold exchanges when they wish to build replacement property on land that they already own. Again, an AT must be used to hold title to the property during the period of time when improvements are being completed. These exchanges may also be used in the reverse format whereby a taxpayer uses the AT to start the construction process on the replacement property prior to the sale of the relinquished property.

Finally, taxpayers should note the ability to complete multi-asset exchanges on the sale of businesses. In these asset sale transactions, a taxpayer will allocate value between the real property and the personal property. Real property comprises land and buildings, while personal property may include furniture, fixtures, equipment, vehicles, aircraft, etc. Many taxpayers are unaware of the ability to complete exchanges on the sale of personal property assets, and should note that many types of assets, including art and collectibles, can qualify for tax-deferred exchange treatment.

#### PLAN PROACTIVELY, NOT REACTIVELY

Many taxpayers do not contemplate using an exchange strategy until a few days prior to closing. While a QI can certainly be engaged on such short notice, the timing challenges eliminate potentially beneficial proactive planning alternatives. This can often prove difficult in situations such as asset sales by a partnership, whereby the partners within the partnership want to accomplish different tax and investing objectives, go their separate ways, restructure the partnership, etc. It is recommended that taxpayers discuss exchange strategies with their tax advisors and QI well in advance of closing, thereby allowing adequate time to properly accomplish the desired exchange objectives.

#### CHOOSE YOUR INTERMEDIARY WISELY

Prior to 2007, a majority of taxpayers and their professional advisors did not ask many questions about the manner in

which the QI held their exchange proceeds. Many assumed the QI was bound by state or federal regulations, much like the rules surrounding an attorney's trust account. Shockingly, QIs were not held to any such regulation and many taxpayers learned this lesson the hard way. Numerous QIs filed for bankruptcy from 2007-2009 for a variety of reasons.

In certain situations, the QI absconded with client money -- fleeing the country with tens of millions of dollars. In other instances the QI co-mingled client funds and held them in less liquid investment vehicles in an effort to obtain more attractive interest rate returns for the QI's own benefit. When these investments became truly illiquid (think auction rate securities backed by Lehman Brothers after Lehman failed), the QI often engaged in Ponzi scheme type activity, whereby the exchange proceeds from new exchanges facilitated by the QI were used to fund other exchanges that were being completed. When transactional real estate came to a halt and there were no new exchange proceeds to cover replacement property closings, the QI was exposed for these non-transparent practices and most filed for bankruptcy.

In light of the above activities, the federal government and a handful of state governments have either enacted or are considering enacting laws that will regulate QIs. In the meanwhile, taxpayers and their advisors should always consider the following: a) Make certain the QI uses segregated accounts -- never use a QI who comingles or pools client funds; b) Inquire as to whether the QI carries both errors & omissions insurance and a fidelity/crime bond; c) Look for QIs that will allow the taxpayer to direct where the exchange proceeds are held

during the exchange as holding the funds in your bank of choice may help alleviate financial institution concerns and often allows you to directly contact your personal banker to confirm funds are present during the exchange process; d) Consider using a dual-signature account, whereby your signature is required prior to the QI moving the funds out of the exchange account -- for larger transactions, the taxpayer may also want to consider using a qualified trust or escrow account; and e) Ask questions of the QI and demand full transparency of all fees, processes, etc. -- arefully select a QI after thoroughly vetting out their structure and processes. Taxpayers and advisors should make a detailed inquiry of their QI prior to using their services.

As 1031 exchange volume continues to increase month over month, these concepts should help summarize key exchange concepts and new developments within the 1031 industry.

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