

Nontaxable, Like-Kind Exchanges under Internal Revenue Code
Section 1031

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**Nontaxable, Like-Kind Exchanges
Under
Internal Revenue Code Section 1031**

Introductory Level

LESSON 1

Introduction

Real estate brokers and agents need to have some basic knowledge of the Internal Revenue Code Section (IRC§) 1031 tax-free exchanges. This introductory course is designed to do just that.

Note: This introductory course will provide you with sufficient background to extend your knowledge of IRC§1031 exchanges, using information available, for free, on the Internet. However, when using secondary sources (e.g., websites promoting their services and non-refereed professional journal articles), exercise caution and please be sure to verify via primary sources (e.g., the IRS or Treasury Department Regulations and/or refereed academic or professional journal articles). Many web-based sources provide insufficient detail, potentially leading to misunderstandings.

The intermediate extension of this introductory course focuses, heavily, on more complex computations and more fully-developed fact patterns. The advanced extension of this and the intermediate course focuses, heavily, on conceptual matters (e.g., contemporary and more complex planning opportunities, frequently the result of recent Treasury Department guidance).

Anecdotal Evidence – Contemporary Problems with IRC§1031 Exchanges

In an article by Jen DeGregorio (reporter), published on May 30, 2005 (Real Estate Swaps Are on the Rise, *Daily Record*,

Baltimore, MD), an increase in flawed IRC§1031 exchanges was noted. Some highlights follow:

- ✓ Poor advice is originating from some mortgage brokers
- ✓ The problems tend to focus on the lack of appropriate tax advice
- ✓ Some are not using qualified intermediaries, which are not required to register with the IRS
- ✓ Mistakes in property analysis or paperwork preparation are becoming increasingly common, as new investors are entering the real estate market
- ✓ Many are unsophisticated and are relying on brokers, often familiar with the 45-day and 180-day deadlines, but not with other IRS guidelines
- ✓ Failures tend to concentrate on the East Coast, since these exchanges have been more popular on the West Coast
- ✓ Strict rules apply to IRC§1031 exchanges, which became legal in 1921 and governed by strict rules adopted in 1991
- ✓ Replacement property must be purchased under the same conditions as the relinquished property

1. Some anecdotal evidence that was noted in a mid-2005 article published in the *Daily Record*, suggesting that some IRC§1031 exchanges were failing due to
 - a. poor advice is originating from some mortgage brokers
 - b. problems that tend to focus on the lack of appropriate tax advice
 - c. failures to use qualified intermediaries, which are not required to register with the IRS
 - d. **All of the above**
2. Some anecdotal evidence that was noted in a mid-2005 article published in the *Daily Record*, suggesting that some IRC§1031 exchanges were failing due to
 - a. mistakes in property analysis or paperwork preparation
 - b. unsophisticated investors, relying on brokers, often familiar with the 45-day and 180-day deadlines, but not with other IRS guidelines
 - c. lack of familiarity with IRC§1031 exchanges, that tend to concentrate on the East Coast, since these exchanges have, historically, been more popular on the West Coast

d. **All of the above**

An IRC§1031 exchange is named for (1) the IRC Section it refers to, but is also known as a (2) Starker exchange, (3) tax-free exchange, or (4) like-kind exchange.

3. An IRC§1031 exchange is also known as
 - a. a Starker exchange
 - b. a taxable exchange
 - c. a tax-free exchange
 - d. **a. and c. only**

4. An IRC§1031 exchange is referred to in this manner due to
 - a. **the IRC Section that it refers to**
 - b. the Starker family, responsible for the drafting of the legislation, while living at 1031 Main Street in Chicago
 - c. its tax-free nature
 - d. its like-kind nature

5. An IRC§1031 exchange is known by all of the below, except
 - a. a Starker exchange
 - b. a tax-free exchange
 - c. a like-kind exchange
 - d. **an exchange for like-kind and tax-free property, held in a Starker Trust**

Personal and Professional Advantages to the Professional Realtor®

The Realtor® can benefit for both personal and professional rewards by maintaining a modest level of competence in IRC§1031 exchanges. In an early 2005 article written by Elyse Umlauf-Garneau, published on February 1, 2005 (Use 1031 Exchanges to Close More Deals: Practitioners Capitalize on Tax Code to Capture Lifelong Clients, *Realtor Magazine Online*), benefits from the time spent to acquire some level of expertise in these transaction were listed. Some highlights follow:

- ✓ “investors” tend to think “long-term,” so good service tends to equal “clients for life”
 - ✓ not knowing the basics of IRC§1031 exchanges may result in a loss of business or clients
 - ✓ clients educated about the benefits of IRC§1031 exchanges are able to buy higher priced properties (i.e., leverage)
 - ✓ investors may exchange one property for two, resulting in three commissions
 - ✓ especially applicable in areas where real estate values have soared, so do not limit yourself to “serial” investors
 - ✓ once expertise is achieved, use your knowledge of IRC§1031 exchanges to promote yourself
 - ✓ taxpayers buying homes for their college-age children near school are also potential clients
 - ✓ may result in access to tenants of income-producing properties – these are future home buyers and potential clients
 - ✓ important to admit ignorance and establish relationships with qualified tax advisors
 - ✓ establish relationships and work with qualified intermediaries
6. Personal and professional advantages with respect to the acquisition of expertise in IRC§1031 exchanges, benefiting the Realtor®, include:
- a. “investors” tend to think “long-term,” so good service tends to equal “clients for life”
 - b. not knowing the basics of IRC§1031 exchanges may result in a loss of business or clients educated about the benefits of IRC§1031 exchanges are able to buy higher priced properties (i.e., leverage)
 - c. investors may exchange one property for two, resulting in three commissions especially applicable in areas where real estate values have soared, so do not limit yourself to “serial” investors
 - d. **All of the above**
7. Personal and professional advantages with respect to the acquisition of expertise in IRC§1031 exchanges, benefiting the Realtor®, include:
- a. once expertise is achieved, use your knowledge of IRC§1031 exchanges to promote yourself taxpayers buying homes for their college-age children near school are also potential clients

- b. may result in access to tenants of income-producing properties – these are future home buyers and potential clients
- c. important to admit ignorance and establish relationships with qualified tax advisors establish relationships and work with qualified intermediaries
- d. **All of the above.**

Relevant Tax Forms and Publications

IRC§1031 tax-free exchanges are reported on (1) Form 8824, but may also involve and require the taxpayer to file a (2) Form 6252, (3) Form 4797, and/or (4) Form 1040, Schedule D (as applicable). The basic instructions for reporting like-kind exchanges, as well as other gains and losses, are contained in Internal Revenue Service (IRS) *Publication 544 – Sales and Other Dispositions of Assets*, available at <http://www.irs.gov>.

An IRC§1031 tax-free exchange may involve the use of several federal income tax forms, as follows:

- ✓ Form 8824 – Like-Kind Exchanges: Applies to and is required for all like-kind exchanges
 - ✓ Form 6252 – Installment Sale Income: Generally, this form only applies when the exchange has a taxable component and involves installments or payments and the results flow into Form 4797 and/or Form 1040, Schedule D
 - ✓ Form 4797 – Sale of Business Property: Generally, this form only applies when the exchange has a taxable component and facilitates the allocation of gains into varying classifications (e.g., ordinary income or long-term capital gains)
 - ✓ Form 1040, Schedule D – Capital Gains and Losses: Generally, this form only applies when the exchange has a taxable component and facilitates the allocation of gains into varying classifications (e.g., ordinary income or long-term capital gains)
8. IRC§1031 exchanges always requires the taxpayer to file
- a. **Form 8824**

- b. Form 6252
 - c. Form 4797
 - d. Form 1040, Schedule D
9. The IRC§1031 exchange may or may not require the taxpayer to file
- a. Form 6252
 - b. Form 4797
 - c. Form 1040, Schedule D
 - d. **All of the above**
10. In the case of an IRC§1031 exchange, which federal income tax form is required when the exchange involves an installment sale?
- a. Form 8824
 - b. **Form 6252**
 - c. Form 4797
 - d. Form 1040, Schedule D

What is a Like-Kind or IRC§1031 Exchange?

“Like-Kind” IRC§1031 exchanges provides a tax deferral alternative to those taxpayers who might otherwise be interested in (1) selling one property or piece of real estate, resulting in a taxable gain, and (2) using the proceeds to purchase another property or piece of real estate. The IRC§1031 tax deferred exchange is just that, tax deferred. The “exchange,” if structured properly, may be nontaxable and result in the legitimate, complete avoidance or deferral of the gain that would otherwise be realized on a “sale.”

The IRC§1031 exchange is not the result of a tax loophole (i.e., error in tax legislation). It is the result of the intentional desire, by Congress, to allow any taxpayer meeting the requirements to sell their property and avoid paying taxes on this (otherwise taxable) gain.

11. The IRC§1031 exchange is
- a. the result of a tax loophole
 - b. the result of an error in tax legislation
 - c. **the result of an intentional desire, by Congress**

- d. the result of an error made by Congress

The IRC§1031 exchange is, perhaps most accurately viewed as an interest-free loan (i.e., tax deferral) from the IRS. It provides a vehicle where the taxpayer may be able to legitimately increase their wealth through subsequent exchanges, never resulting in a payment of tax on capital gains, but only through proper tax planning.

- 12. The IRC§1031 exchange may be (accurately) viewed as all of the following, except
 - a. an interest-free loan from the IRS
 - b. a tax deferred investment
 - c. **an illegitimate means of committing fraud against the IRS**
 - d. a vehicle through which gains may be deferred, forever, with proper tax planning

As applied to real property, the IRS provides for 4 classifications, as follows:

- ✓ real property held for use in a trade or business (e.g., rental property)
- ✓ real property held for investment
- ✓ real property held for personal use (i.e., personal residence)
- ✓ real property held primarily for sale (i.e., dealer property or inventory)

The first two classifications of real property qualify for IRC§1031 exchanges and tax deferral. The latter two do not.

- 13. All of the following would qualify for an IRC§1031 exchanges and tax deferral treatment, except
 - a. purchase of an owner's personal residence, for your use as a rental property
 - b. exchanging raw land for a duplex, to be used as a rental property
 - c. **the sale of your personal residence, in exchange for raw land**
 - d. exchanging two rental units for three rental units

Why Pursue a Like-Kind or IRC§1031 Exchange?

	Option 1 Sale & Purchase	Option 2 Exchange
Sales Price/Fair Market Value	\$100,000	na
less: Cost or Adjusted Basis	<u>\$ 50,000</u>	na
equals: Taxable Gain	<u>\$ 50,000</u>	na
Taxed at 25%:		
Fair Market Value	\$100,000	\$100,000
less: Tax (\$50,000 x 25%)	<u>\$ 12,500</u>	<u>\$ -0-</u>
equals: Remaining Equity (12.5% equity lost)	<u>\$ 87,500</u>	<u>\$100,000</u>
Taxed at 15%:		
Fair Market Value	\$100,000	\$100,000
less: Tax (\$50,000 x 15%)	<u>\$ 7,500</u>	<u>\$ -0-</u>
equals: Remaining Equity (7.5% equity lost)	<u>\$ 92,500</u>	<u>\$100,000</u>
Taxed at 5%:		
Fair Market Value	\$100,000	\$100,000
less: Tax (\$50,000 x 5%)	<u>\$ 2,500</u>	<u>\$ -0-</u>
equals: Remaining Equity (2.5% equity lost)	<u>\$ 97,500</u>	<u>\$100,000</u>

Table 1

Table 1 illustrates the impact of a **sale and purchase** sequence of transactions (option 1) versus a **tax-free exchange** (option 2). This case assumes that a piece of real estate, for example, has a fair market value and/or selling price at \$100,000. It further assumes that the property has a cost or adjusted basis of \$50,000, resulting in a potential gain of \$50,000.

14. The motivation for a taxpayer to seek to replace real property through a like-kind, tax deferred or tax-free exchange (e.g., IRC§1031), as opposed to a (1) sale and (2) purchase, might include
 - a. The preservation of equity or wealth
 - b. The reduction of tax, a cash outflow
 - c. The reduction of real estate sales commissions
 - d. **a. and b., only.**

Additional Motivating Factors for Pursuing Like-Kind Exchange Treatment

The deferral of tax available through an IRC§1031 or tax-free exchange is a significant factor in the taxpayer's decision-making process, but it is not the only consideration. Consider the following, additional motivating factors:

- ✓ Exchange for a property of greater value, resulting from and partially or fully financed by tax deferral/savings (i.e., leveraging)
- ✓ Exchange non-revenue-generating property (e.g., raw land) for income-producing property (e.g., residential rental property)
- ✓ Exchange non-depreciable property (e.g., raw land) for income-producing property with improvements that generate depreciation (e.g., rental property)
- ✓ Exchange property in an already fully appreciated area for one in an area where you anticipate appreciation
- ✓ Exchange property in an area where property values are declining and gentrification is not anticipated for one in an area in the early stages of its life-cycle
- ✓ Exchange economically or functionally obsolete property, where repairs and costs of maintenance are increasing, for a newer property

15. In addition to tax deferral, the IRC§1031 exchange may allow the taxpayer to
 - a. exchange non-revenue-generating property (e.g., raw land) for income-producing property
 - b. exchange non-depreciable property (e.g., raw land) for income-producing property with improvements that generate depreciation (e.g., rental property)
 - c. exchange property in an already fully appreciated area for one in an area where you anticipate appreciation
 - d. **All of the above represent motivating factors for a taxpayer to pursue an IRC§1031 exchange**

Disadvantages of Like-Kind Exchange Treatment

There are only two disadvantages to the IRC§1031 tax-free exchange:

- ✓ Lower tax basis and, therefore, lower depreciation (i.e., depreciable base)
- ✓ Losses from tax deferred or tax-free exchanges cannot be deducted

The first disadvantage is really not a disadvantage. Generally, this “disadvantage” is comparable to suggesting that “because I did not pay tax today, I cannot take a larger tax deduction and reduce tax tomorrow.” The whole idea of tax deferral is to preserve wealth. A basic understanding of time value of money considerations is, typically, sufficient to understand how this so-called “disadvantage” really has no merit. The second disadvantage is, however, a relevant one, though easily avoided. Simply stated, if a loss is anticipated or desirable, do a sale and do not do an exchange.

16. The disadvantages to an IRC§1031 tax-free exchange include
 - a. the inability of the taxpayer to recognize a tax loss, otherwise available, in the case of a sale
 - b. the tax deferral resulting from the exchange
 - c. a lower tax basis for depreciation
 - d. **both a. and c., though c. is debatable, as it suggest some misconception with respect to the notion of tax deferral and time value of money considerations**

17. If the taxpayer anticipates that a tax loss will result from an exchange, it is preferable to
 - a. **avoid or violate the conditions required under IRC§1031, so that the exchange will not be tax-free and the loss will be deductible**
 - b. retains the property and transfers it to his or her heirs
 - c. do the IRC§1031 tax-free exchange anyway
 - d. converts the property to their personal residence

LESSON 2

The IRC§1031 Tax-Free Exchange is not an “Election”

IRC§1031 is not an elective provision. It is mandatory. If the exchange qualifies as like-kind, non-recognition of gain or loss on the exchange is mandatory. Therefore, if a taxpayer prefers to recognize a loss on an exchange transaction, he or she must structure the transaction to avoid having it qualify as a like-kind exchange.

1. IRC§1031 is
 - a. elective
 - b. mandatory**
 - c. elective for gains
 - d. mandatory for losses

2. If a taxpayer prefers to recognize a loss on an exchange transaction qualifying as a like-kind exchange
 - a. the taxpayer need not elect IRC§1031
 - b. the taxpayer must file a form with the IRS to avoid the mandatory imposition of IRC§1031
 - c. the taxpayer must structure the transaction to avoid having it qualify as a like-kind exchange**
 - d. the taxpayer must carry the loss forward

Applicable Long-Term Capital Gains Tax Rates – 2004 and 2005

Though state tax rates are also likely to apply, typically, at ordinary income tax rates, only federal income tax rates are illustrated in Table 1, at 25 percent (for recapture of IRC§1250 gain), 15 percent (for taxpayers in the 25, 28, 33, and 35 percent tax brackets or marginal federal income tax rates) and 5 percent (for taxpayers in the 5 and 10 percent tax brackets or marginal federal income tax rates). These rates, for the 2004 and 2005 tax and calendar years, are illustrated in Table 2.

2004-2005 Marginal Federal Income Tax Rate or Tax Bracket	Applicable Long-Term Capital Gains Tax Rate
5%	5%
10%	5%
25%	15%
28%	15%
33%	15%
35%	15%

Table 2

3. The applicable long-term capital gains tax rate(s) for the 2004 and 2005 calendar and tax years is
 - a. 5 percent.
 - b. 15 percent.
 - c. **5 percent or 15 percent, depending on the taxpayer's marginal federal income tax rate or bracket.**
 - d. 25 percent.

4. The applicable long-term capital gains tax rate(s) for the 2004 and 2005 calendar and tax years for recapture of IRC§1250 gain is
 - a. 5 percent.
 - b. 15 percent.
 - c. 5 percent or 15 percent, depending on the taxpayer's marginal federal income tax rate or bracket.
 - d. **25 percent.**

Qualifying Property

Qualifying property must be held for investment or the production of income in your trade or business and, in a like-kind exchange, both the property given up and the property received must meet these criteria. Property used for personal purposes (e.g., your personal residence, covered by IRC§1034, and already providing for certain tax exclusions under IRC§121) does not qualify. However, this does not prevent the buyer in an exchange

transaction for qualifying this property, if it is, for example, to be used as a residential rental property for the production of income.

5. Property qualifying for a like-kind exchange must be
 - a. held for investment
 - b. held for the production of income in your trade or business
 - c. include your personal residence
 - d. **a. and/or b.**

6. If your replacement property is the seller's personal residence
 - a. **the seller will not be eligible for an IRC§1031 exchange**
 - b. you (the buyer) will be eligible for an IRC§1031 exchange, but only if the buyer also intends to use the property as their personal residence
 - c. the seller will be eligible for IRC§1031 exchange treatment, but only if the buyer's intent is to use the property as a residential rental
 - d. you (the buyer) should avoid the purchase of this property

Excluded Property

Property excluded, for the purposes of IRC§1031 tax deferral treatment, follow:

- ✓ Property used for personal purposes (e.g., personal automobile or residence)
- ✓ Stocks in trade or other "inventory" held for sale or resale, including short-term real estate holdings by "dealers"
- ✓ Short-term or current assets, including accounts receivable and debt and equity securities
- ✓ Partnership interests, certificates of trust or beneficial interest, and choses in action

The above may, however, qualify for other forms of nontaxable exchanges, outside of IRC§1031.

7. Which of the below qualifies for IRC§1031 tax deferral treatment?
 - a. Property used for personal purposes (e.g., personal automobile or residence)
 - b. Stocks in trade or other "inventory" held for sale or resale, including short-term real estate holdings by "dealers"

- c. Short-term or current assets, including accounts receivable and debt and equity securities
 - d. **Property used for investment and/or trade or business purposes**
8. Which of the below is specifically excluded for IRC§1031 tax deferral treatment?
- a. farm property
 - b. raw land
 - c. **personal use property (e.g., personal residence)**
 - d. residential rental property

Like-Kind Property

Like-Kind properties are those that are the same in *nature* or *character*. They may differ in *grade* or *quality*. Therefore, as applied to real property, the exchange of a city property for a farm property would represent a like-kind exchange. Similarly, the exchange of an improved property for an unimproved property would qualify for and represent a like-kind exchange.

Furthermore, the exchange of real estate for a real estate lease than has a life of 30 years or longer is a like-kind exchange.

However, some interests in real property do not qualify. For example, the exchange of a life estate of less than 30 years for a remainder interest does not qualify as a like-kind exchange.

Alternatively, the exchange of a remainder interest in real estate for a remainder interest in other real estate would qualify as a like-kind exchange if the *nature* or *character* of the two real property interests is the same. Finally, foreign real property (e.g., not located in the United States or the District of Columbia) and real property located within the United States is not considered like-kind property.

9. The following would not be considered like-kind property:
- a. city real property for farm real property
 - b. improved real property for unimproved real property
 - c. real estate for a 35-year real estate lease
 - d. **foreign real property for real property located within the United States**

An exchange does not qualify as like-kind unless belonging to the same class. For example, an exchange of real property for personal property (or visa versa) would not qualify under IRC§1031 and would not be tax-free.

10. The following would not be considered like-kind property:
 - a. **a personal use automobile for a income-producing real property**
 - b. improved real property for unimproved real property
 - c. real estate for a 35-year real estate lease
 - d. farm real property for single family residential real property to be used as a rental

Like-Kind Exchanges through Qualified Intermediaries

A *qualified intermediary (QI)* is one engaged, with a written agreement, to broker or arrange for the exchange and transfer of the properties. The QI must (1) acquire the relinquished property from the seller, (2) transfer the relinquished property to the buyer, (3) acquire the replacement property for the buyer, and (4) transfer this replacement property to the buyer. Any agreements with qualified intermediaries must expressly limit the taxpayer's rights to receive, pledge, borrow, or otherwise benefit from money or other property. It should also be noted that the use of a QI does not, in and of itself, provide a legitimate vehicle for the avoidance of rules concerning "related parties" and related party transactions.

11. A *qualified intermediary* must do all of the following, except
 - a. acquire the relinquished property from the seller
 - b. transfer the relinquished property to the buyer
 - c. acquire the replacement property for the buyer
 - d. **select up to three replacement properties**

12. The use of a *qualified intermediary* will not
 - a. **permit the taxpayer to avoid related party rules and restrictions**
 - b. transfer the relinquished property to the buyer
 - c. acquire the replacement property for the buyer
 - d. transfer this replacement property to the buyer

Cautionary Note: A simple key word search on the Internet, using “1031,” will provide an introduction to a variety of qualified intermediaries (QIs) (e.g., Asset Preservation, Inc. at <http://apiexchange.com>). Fees for assistance with exchanges are noted at one site (i.e., 1031 Corporation at <http://www.1031cpas.com>) at \$500 for simultaneous exchanges and \$300 to \$500 for each property (per \$1 million of sales price) for delayed exchanges (see below). (Similarly, many articles have been written on this topic and can be accessed using search engines, e.g., Dogpile at <http://www.dogpile.com> or Google at <http://www.google.com>). The information contained in these and other “secondary” sources may be incorrect or outdated and, so, should be verified and/or discussed with your tax accountant and/or tax attorney.)

Four Basic Types or Classifications of Exchanges

The four basic types or classifications of exchanges, along with brief definitions, follow:

- ✓ Simultaneous – closing of relinquished and replacement properties occur on the same day
- ✓ Delayed – closing is not simultaneous, but sequential; also known as a “Starker Exchange” (so named after the well known Supreme Court case, ruling in the taxpayer’s favor). A delayed exchange results in (1) the sale of the relinquished property, (2) the identification of the appropriate or desired replacement property (within 45 days from closing on the relinquished property), and (3) the purchase of the replacement property, all occurring within the maximum allowable time period of 180 days.
- ✓ Reverse – closing sequence is reversed; the replacement property is identified, purchased and closed before the relinquished property is sold. A form of “Title-Holding” exchange and usually involving an intermediary.

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- ✓ Improvement – closing occurs after improvements are made to the replacement property. A form of “Title-Holding” exchange that may be performed as “Delayed” or “Reverse” exchange.
13. An IRC§1031 tax deferred exchange, where the sale and/or closing takes place only after improvements are made to the replacement property is known as
- a simultaneous exchange
 - a delayed exchange
 - a reverse exchange
 - an improvement exchange**
14. An IRC§1031 tax deferred exchange, where the sales and/or closing on the replacement property occurs prior to the closing of the relinquished property is known as
- a simultaneous exchange
 - a delayed exchange
 - a reverse exchange**
 - an improvement exchange
15. An IRC§1031 tax deferred exchange, where the sale and/or closing on the relinquished property occurs prior to the sale and/or closing of the replacement property is known as
- a simultaneous exchange
 - a delayed exchange**
 - a reverse exchange
 - an improvement exchange
16. An IRC§1031 tax deferred exchange, known as a “Starker Exchange,” is also known as
- a simultaneous exchange
 - a delayed exchange**
 - a reverse exchange
 - an improvement exchange
17. An IRC§1031 tax deferred exchange, where sale and/or closing of the relinquished and replacement properties occur on the same day is referred to as
- a simultaneous exchange**
 - a delayed exchange

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- c. a reverse exchange
- d. an improvement exchange

LESSON 3

The 45-Day Rule (Identification) and the 180-Day Rule (Purchase)

Taxpayers have 45 days after the sale of the relinquished property to identify up to three replacement properties. The 45-day period includes weekends and holidays and, if the 45th day falls on a Saturday, Sunday or holiday, paperwork must be completed by the prior business day or the transaction will be disqualified. This is referred to as the “identification period.”

Taxpayers have 180 days after the sale of the relinquished property to close on the purchase of the replacement property. This is referred to as the “exchange period.” These rules are very strict, but extensions have occurred in the case of September 11, 2001 and natural disasters (e.g., Hurricane Katrina in New Orleans).

Generally, the taxpayer notifies their intermediary, in writing, of the properties desired. A contract is not necessary at this time, but the property that you (eventually) buy must come from this list.

1. After the sale of a property, taxpayers have
 - a. 45 days, including weekends and holidays, to identify a single replacement property
 - b. 45 days, excluding weekends and holidays, to identify a single replacement property
 - c. **45 days, including weekends and holidays, to identify up to three replacement properties**
 - d. 45 days, excluding weekends and holidays, to identify up to three replacement properties
2. After the sale of a property, taxpayers have
 - a. 45 days, including weekends and holidays, to purchase the replacement property
 - b. 45 days, excluding weekends and holidays, to purchase the replacement property

- c. **180 days, including weekends and holidays, to purchase the replacement property**
- d. 180 days, excluding weekends and holidays, to purchase the replacement property

Dobrich vs. Commissioner – The Importance of the 45-Day Identification Rule

In *David Dobrich and Naomi Dobrich, Petitioners v. Commissioner of the Internal Revenue, Repondent; USTC Tax Court Memorandum 1997-477* (October 20, 1997), the taxpayers were found by the IRS to be deficient for their 1989 and 1990 federal income tax in amounts of \$1,111,292 and \$1,111,320, respectively. IRC§6663(a) civil fraud penalties of \$833,469 (1989) and \$833,490 (1990) were also imposed. (Note that state income tax counterparts, if applicable, are not available, but would contribute to and have to be added to these amounts relating only to the federal level).

The fraud penalties were imposed and associated with their efforts to manufacture documentation to backdate and support the identification of the replacement properties they purchased within the timeframe permitted by the 45-day identification rule.

Selected relevant dates follow:

- ✓ September 19, 1989 - List of 10 potential replacement properties fail to include Skyland or Pleasant Hill as replacement properties
- ✓ October 6, 1989 - 45-day identification period expiration date
- ✓ January 26, 1990 - Offer to purchase Pleasant Hill property for \$3.1 million
- ✓ January 26, 1990 - Offer to purchase Skyland property for \$1.2 million
- ✓ February 15, 1990 - Pleasant Hill replacement property purchased
- ✓ February 15, 1990 - Skyland replacement property purchased
- ✓ February 1990 - 180-day replacement period expires

David and Naomi Dobrich were successful in achieving a nominal reduction of tax and civil fraud-related penalties for the 1989 tax year (a \$6,236 reduction of the combined tax and penalty amounts of \$1,944,761). However, combined 1989 and 1990 capital gains taxes of \$2.2 million for failure to comply with the 45-day replacement property identification rule and the fraud penalties of \$1.7 million, associated with their efforts to backdate documents, in their failed and fraudulent attempt to provide evidence of compliance with the 45-day replacement property identification rule, illustrate both the importance of strict compliance with this rule and the consequences of failure to comply with it, as well as the consequences of fraud.

3. Dobrich vs. Commissioner illustrates the importance of
 - a. **strict adherence to the 45-day replacement property identification rule**
 - b. strict adherence to the 180-day replacement property purchase rule
 - c. strict adherence to the IRS guidelines for backdating documents
 - d. strict adherence to the 3-property rule

4. In the case of Dobrich vs. Commissioner
 - a. taxpayer's failed to identify purchased replacement properties in accordance with the requirements established in what is known as the 45-day rule
 - b. taxpayer's attempted to backdate documents to support their timely identification of purchased replacement properties
 - c. taxpayer's had to pay capital gains taxes, as their failure to follow the requirements of IRC§1031 resulted in disallowance of tax deferral
 - d. **All of the above**

More on the 180-Day Rule or Purchase Deadline

The 180-day requirement is quite strict and is more precisely defined as 'within 180 days OR the tax filing date, whichever is earlier,' as the following case illustrates:

In Orville Christensen v. Commissioner, 98-1. USTC ¶150,352 (Ninth Circuit Court of Appeals), the

Christensen's transferred business property to a facilitator on December 22, 1998, identified the replacement properties on February 3, 1989 (easily within the 45 day window permitted for "identification"), and received the properties between April 25 and June 20, 1989 (easily within the 180 day window permitted for "purchase"). However, the Christensen's filed their tax return on April 15, 1989, prior to the expiration of the 180 days. The purchase of replacement properties occurred AFTER their tax return was filed.

The IRS prevailed in the above case and the tax-free or tax deferred nature of this "would be" IRC§1031 exchange transaction was disallowed. The Christensen's should have filed an extension on April 15, 1989, to benefit from the full 180 days otherwise available to complete the purchase.

5. The 180-day rule is qualified, in that the taxpayer must complete the exchange prior to
 - a. the lesser of 180 days or the tax return filing date
 - b. the earlier of the 180 days or the taxpayer's tax return filing date
 - c. the tax return filing date, if earlier than the conclusion of 180 days
 - d. **All of the above are correct**

6. The 180-day purchase date rule or requirement may fall on a date following the April 15th tax return filing date. To take full advantage of the 180-day rule, taxpayers should
 - a. complete the purchase of the replacement property prior to April 15th
 - b. **file an extension**
 - c. telephone their local IRS agent and ask him or her if it is okay to file your tax return on April 15th and complete the purchase of the replacement property AFTER April 15th, but before the expiration of the 180-day period.
 - d. attach a note to your tax return, filed in a timely manner on April 15th

Knight vs. Commissioner – The Importance of the 180-Day Purchase Rule

In *David A. and Marilyn P. Knight, Petitioners v. Commissioner of the Internal Revenue, Respondent; USTC Tax Court Memorandum 1998-107 (March 16, 1998)*, the taxpayers were found to have failed in their efforts to comply with the 180-day purchase rule. The fact that circumstances, quite possibly beyond their control, prevented them from complying with this deadline was not relevant. The taxpayers had to pay an additional \$27,412 in (1993) federal income tax (additional ordinary income of \$16,266 and additional capital gains of \$82,288). (Note that state income tax counterparts, if applicable, are not available, but would contribute to and have to be added to these amounts relating only to the federal level). Selected relevant dates follow:

- ✓ February 17, 1993 - Sale of 99th Street rental property (relinquished)
- ✓ February 19, 1993 - Sale of West Center Street rental property (relinquished)
- ✓ April 2, 1993 - Identification of 3 potential replacement properties
- ✓ August 16, 1993 - Negotiations failed; sellers cancelled sale the day prior to expiration of the 180-day deadline of August 17, 1993
- ✓ December 23, 1993 - One of the 3 potential replacement properties, properly identified within the 45-day replacement property identification deadline, was purchased, but after the 180-day deadline

7. Knight vs. Commissioner illustrates the importance of
 - a. strict adherence to the 45-day replacement property identification rule
 - b. strict adherence to the 180-day replacement property purchase rule**
 - c. strict adherence to the IRS guidelines for backdating documents
 - d. strict adherence to the 3-property rule
8. In the case of Knight vs. Commissioner

- a. taxpayer's failed to identify purchased replacement properties in accordance with the requirements established in what is known as the 45-day rule
- b. taxpayer's attempted to backdate documents to support their timely identification of purchased replacement properties
- c. taxpayer's had to pay fraud penalties
- d. **taxpayer's failed to meet the requirements of the 180-day rule, resulting in disallowance of the deferral of capital gains**

Christensen vs. Commissioner – The 180-Day Purchase Rule, as Affected by Tax Return Filing Dates and Extensions

In *Orville E. Christensen and Helen V. Christensen, Petitioners v. Commissioner of the Internal Revenue, Respondent; USTC Tax Court Memorandum 1996-254 (June 3, 1996)*, the taxpayers were found to have, effectively, reduced the 180-day purchase rule by filing their tax return on the due date, April 17, 1989. Had they filed an application for an automatic extension (Form 4868) and delayed the filing of their federal income tax return through the date extended, they would have succeeded in complying with the requirements for the IRC§1031 exchange. They did not do this, however, and had to pay federal income taxes in excess of \$200,000. Selected relevant dates follow:

- ✓ April 17, 1989 - Tax return filed by Orville and Helen Christensen
- ✓ April 25, 1989 - Purchase of 1st replacement property
- ✓ April 26, 1989 - Purchase of 2nd replacement property
- ✓ May 1, 1989 - Purchase of 3rd replacement property
- ✓ June 12, 1989 - Purchase of 4th replacement property
- ✓ June 16, 1989 - Purchase of 5th replacement property
- ✓ June 20, 1989 - Purchase of 6th replacement property

The Court noted that “Congress amended, in the Deficit Reduction Act of 1984, Pub. L. 98-369 (DEFRA), sec. 77(a), 98 Stat. 494, 595, the provisions of section 1031 by adding a new paragraph (3) to section 1031(a),” as follows:

(3) ...For purposes of this subsection...shall be treated as property which is **not** (emphasis added) like-kind property if--

(B) ...received after the **earlier of** (emphasis added)--

(i) ...the day which is 180

days..., **or** (emphasis added)

(ii) the due date (determined with regard to extension) for the transferor's return of the tax imposed by this chapter for the taxable year in which the transfer of the relinquished property occurs.

Therefore, the transfer of replacement property must occur before the earlier of (1) the 180 days or (2) the tax return due date. Had the Christensen's simply filed a Form 4868 for automatic extension, they would have avoided the tax imposed by the IRS and upheld by the Tax Court.

9. Christensen vs. Commissioner illustrates the importance of
 - a. strict adherence to the 45-day replacement property identification rule
 - b. strict adherence to the 180-day replacement property purchase rule
 - c. **strict adherence to the 180-day replacement property purchase rule and how it might be affected by tax return filing dates and extensions**
 - d. strict adherence to the 3-property rule

10. In the case of Christensen vs. Commissioner
 - a. taxpayer's failed to identify purchased replacement properties in accordance with the requirements established in what is known as the 45-day rule
 - b. taxpayer's attempted to backdate documents to support their timely identification of purchased replacement properties
 - c. **taxpayer's failed to meet the requirements of the 180-day rule, effectively reducing the time period otherwise available to them to close on or purchase replacement properties when they failed to**

- file an extension and, instead, filed their tax return on the April due date**
- d. taxpayer's failed to meet the requirements of the 180-day rule, resulting in disallowance of the deferral of capital gains
11. Which is true of both Knight vs. Commissioner and Christensen vs. Commissioner?
- a. **In both cases, the 180-day replacement property rule was not met**
 - b. In both cases, the 45-day replacement property identification rule was not met
 - c. In both cases, both the 180-day replacement property and the 45-day replacement property identification rules were not met
 - d. In both cases, the taxpayers were found guilty of fraud

Replacement Property Identification

There are rules and exemptions associated with replacement property identification, as follows:

- ✓ 3-property rule – the taxpayer may select any three qualifying replacement properties as possible replacements for the relinquished property

For those wishing to exceed the 3-property rule or ceiling (above):

- ✓ 200% rule – the taxpayer may identify any number of qualifying properties as possible replacements for the relinquished property as long as their aggregate fair market value does not exceed 200 percent of the value of the relinquished property

For those wishing to avoid application of the fair market value rule or ceiling (above):

- ✓ 95% exemption – the taxpayer may identify any number of qualifying properties as possible replacements for the relinquished property as long as the result in the purchase of at least 95 percent of the aggregate value of all properties identified

In summary, you only have to satisfy 1 of the 3 rules (above) – not all 3 of them!

12. Under the 3-property rule
 - a. the taxpayer must select at least three qualifying replacement properties as possible replacements for the relinquished property
 - b. the taxpayer may select any three qualifying replacement properties as possible replacements for the relinquished property**
 - c. the taxpayer must select more than three qualifying replacement properties as possible replacements for the relinquished property
 - d. the taxpayer must select qualifying replacement properties as possible replacements for the relinquished property, but this must be done in multiples of three

13. Under the 200% rule
 - a. the taxpayer may identify their three qualifying properties (see 3-property rule) as possible replacements for the relinquished property, but only as long as their aggregate value does not exceed 200 percent of the value of the relinquished property
 - b. the taxpayer may identify any number of qualifying properties as possible replacements for the relinquished property as long as their aggregate value does not exceed 200 percent of the value of the relinquished property**
 - c. the taxpayer may identify their three qualifying properties (see 3-property rule) as possible replacements for the relinquished property, but only as long as their aggregate value exceeds 200 percent of the value of the relinquished property
 - b. the taxpayer may identify any their three qualifying properties (3-property rule) as possible replacements for the relinquished property, but only in those cases where the aggregate value of the replacements exceeds 200 percent of the value of the relinquished property

14. Under the 95% exemption
 - a. the taxpayer may identify any number of qualifying properties as possible replacements for the relinquished property as long as the result in the purchase of at least 95 percent of the aggregate value of all properties identified**
 - b. the taxpayer may identify more than three qualifying properties as possible replacements for the relinquished property as long as the result in the purchase of less than 95 percent of the aggregate value of all properties identified

- c. the taxpayer may identify less than three qualifying properties as possible replacements for the relinquished property as long as the result in the purchase of less than 95 percent of the aggregate value of all properties identified
 - d. the taxpayer may identify any number of qualifying properties as possible replacements for the relinquished property as long as the result in the purchase of less than 95 percent of the aggregate value of all properties identified
15. Which is the best answer? Replacement property rules that must be complied with include
- a. The 3-property rule
 - b. the 200 percent rule
 - c. the 95 percent rule
 - d. **any 1 of the 3 rules – either (1) the 3-property rule, (2) the 200 percent rule, OR (3) the 95 percent rule**

Nontaxable Exchanges

To “completely” defer/avoid tax in a properly executed IRC§1031 exchange, the following steps are essential:

1. The taxpayer must buy replacement property with a fair market value equal to or greater than that of the property relinquished;
 2. The taxpayer must use all of the original equity realized from the sale of the relinquished property to purchase the replacement property; and
 3. The taxpayer must secure financing of an equal or greater amount on the replacement property, when compared to the amount financed on the relinquished property at the time of its sale.
16. To completely defer/avoid tax in a properly executed IRC§1031 exchange, the taxpayer must
- a. buy replacement property with a fair market value equal to or greater than that of the property relinquished
 - b. use all of the original equity realized from the sale of the relinquished property to purchase the replacement property

Nontaxable, Like-Kind Exchanges Under Internal Revenue Code Section 1031

- c. secure financing of an equal or greater amount on the replacement property, when compared to the amount financed on the relinquished property at the time of its sale
- d. **All of the above**

Partially Nontaxable/Taxable Exchanges

Some “exchanges” include (1) money or (2) unlike property. If a gain is realized, you may be taxed on this gain, but only to the extent of the combined total of the money and the fair market value of the unlike property received. (Note that any “loss” on a nontaxable or tax deferred exchange is never deductible).

The maximum amount of your taxable gain is (1) the fair market value of any unlike property received *plus* (2) any money received *less* (3) any closing costs you paid. Your taxable gain is the lesser of this amount or that amount you might pay on a taxable exchange.

Note: Partially taxable exchanges represent a relatively complex area of taxation and are a topic covered at the intermediate and advanced levels.

Nontaxable, Like-Kind Exchanges under Internal Revenue Code
Section 1031

Nontaxable, Like-Kind Exchanges under Internal Revenue
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