2004 Tax School

1031 Exchange Pitfalls

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Presented by

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I.R.C. Section 1031 Like-Kind Exchanges: Tips and Traps

I. EXCHANGE TERMINOLOGY

Exchanger:

The party desiring to execute a Section 1031 tax-deferred exchange. The Exchanger is often referred to as the "Taxpayer."

Relinquished Property:

Property currently owned by an exchanger that will be traded for new property.

Replacement Property:

Property to be acquired by an exchanger in place of the exchanger's old property.

Qualified Intermediary:

An independent third party who acts as a conduit and facilitator for a Section 1031 exchange. Duties of a qualified intermediary typically include preparation of exchange documentation, holding of relinquished property proceeds in trust, and ensuring that the transaction complies with I.R.S. safe-harbor guidelines.

Delayed Exchange:

When an exchanger, most commonly utilizing the qualified intermediary safe-harbor, first sells relinquished property and subsequently acquires replacement property. Subject to certain rules, the taxpayer has up to 180 days from the transfer of the relinquished property to acquire replacement property.

Reverse Exchange:

A reverse exchange occurs when an exchanger, utilizing the services of a qualified intermediary and an exchange accommodation titleholder (EAT), acquires replacement property before disposing of relinquished property. In a reverse exchange, Section 1031 requires that the EAT take actual title to the replacement property until the relinquished property is sold. Reverse exchanges benefit an exchanger when the taxpayer must purchase the replacement property

before being able to sell the relinquished property. To fall within the safe-harbor of Section 1031, the transaction must be completed within a 180-day time period.

Improvement Exchange:

Exchangers that desire to construct improvements on replacement property, utilizing relinquished property proceeds on deposit with a qualified intermediary, can do so by structuring the transaction as an improvement exchange. Improvement exchanges are similar to reverse exchanges in that an EAT must take actual title to the replacement property while it is under construction. To fall within the safe-harbor of Section 1031, the transaction must be completed within the 180-day time period.

Non-Safe-Harbor Build-to-Suit Exchange:

In some circumstances, improvement exchanges cannot be completed within the 180-day safe-harbor period. For such occasions, a Section 1031 exchange can be structured outside of the safe-harbor provisions of Section 1031 and still qualify for tax-deferral treatment. In this instance, a third party must take actual title to the property and have a beneficial and significant interest in the transaction.

Identification Period:

The 45-day period of time, beginning on the date of closing on the relinquished property, during which an exchanger can identify replacement properties.

Exchange Period:

The 180-day period of time, beginning on the date of closing on the relinquished property, during which an exchanger must acquire replacement properties.

II. I.R.C. SECTION 1031 OVERVIEW

Real estate and property owners who hold property for investment or for productive use in a trade or business are eligible for tax deferment of capital gains taxes as authorized by Section 1031 of the Internal Revenue Code (I.R.C.). Section 1031 should not be confused with the personal residence capital gains tax exemption provisions of the I.R.C. Section 121. By utilizing Section 1031, a taxpayer can defer payment of capital gains taxes each time an exchange is done until an exchanged property is sold and cash proceeds are received.

By utilizing Section 1031, a qualifying taxpayer who sells property may reinvest the entire proceeds of the sale, including amounts ordinarily paid as capital gains tax, into one or more "like-kind" properties. "Like-kind" property is property that is similar in nature or character. Examples of like-kind property include: rental properties, farms and ranches, offices, motels and hotels, golf courses, raw land, retail properties, industrial properties, and properties leased for thirty years or more. Personal property is not like-kind to real property.

Most tax-deferred exchanges are classified as delayed exchanges. A basic delayed exchange occurs when a taxpayer sells "relinquished" property and exchanges it for a "replacement" property within a 180-day time period. The taxpayer must adhere to other specific procedures and time period limitations.

To accomplish a successful tax-deferred exchange, taxpayers must specifically structure their transaction so that it falls within an IRS safe-harbor. The safest and most common safe harbor method for structuring a tax-deferred exchange is for an exchanging taxpayer to utilize the services of a qualified intermediary. Careful attention must be paid by the exchanging taxpayer to ensure that a qualified intermediary has been hired prior to the sale of the relinquished property and to ensure that the taxpayer or the taxpayer's agents do not receive any of the proceeds from the sale.

Certain persons are disqualified by Section 1031 from serving in the capacity of a qualified intermediary. Disqualified parties include a taxpaying exchanger's employee, attorney, accountant, investment banker/broker or real estate agent/broker. This restriction applies if the taxpayer's agent has served in such a capacity within the two years prior to the exchange transaction. Disqualified parties additionally include certain family members such as parents, siblings, spouses, and children; and certain business entities owned by the taxpayer. This is not an exhaustive list of persons who may be disqualified.

III. BASIC SECTION 1031 RULES

The 45-Day Identification Time Limitation:

After the taxpayer sells the original relinquished property, two very important time limitations come into play. The limitations are classified as the 45-day identification period and the 180-day exchange period. There are no exceptions or extensions. Should these time periods be violated, the exchange will fail.

The 45-day exchange period starts after the sale of the original relinquished property. After the closing on the relinquished property, the exchanger has 45 days to identify the replacement property. In the case of an exchange involving multiple relinquished properties, the 45-day exchange period begins upon the sale of the first relinquished property.

Property Identification Rules:

An exchanger may identify as many as three replacement properties, regardless of their total value (the "3-Property Rule"), or the exchanger may identify any number of properties provided their aggregate fair market value on the 45th day does not exceed 200% of the aggregate fair market value of all of your relinquished property on the date of its transfer (the "200% Rule"). If an exchanger stays within these rules, they need not acquire all of the property identified. A third rule (the "95% Rule), applies to situations where the exchanger cannot comply with the 3-Property or 200% Rules. Under the 95% Rule an exchanger can identify any number of properties, without regard to their fair market values, as long as 95% of the properties are actually acquired.

The 180-Day Exchange Period:

After proper identification of the replacement properties, closing must be completed by the earlier of:

(a) 180 days following transfer of the exchanger's relinquished property; or in the event of multiple relinquished properties, 180 days following the transfer of the first property; or

(b) The due date for the exchanger's federal income tax return for the year in which the old property was relinquished. In some cases, an extension for filing the exchanger's income tax return must be requested in order to receive the entire 180 days.

Avoiding All Taxable Gain:

As a general rule, exchanging taxpayers should keep three important considerations in mind.

First, the replacement property's fair market value must be equal to or greater than the fair market value of the relinquished property. Second, all of the exchange proceeds from the sale of the relinquished property must be used to acquire the replacement party. Third, the replacement property debt must be equal to or greater than the relinquished property debt so as to avoid taxable gain due to debt relief.

Not following these rules may result in taxable gain. These three considerations are mentioned to help exchanging taxpayers structure a Section 1031 exchange. If an exchanger does not follow them, an exchange can still be accomplished. However, it is extremely important for the exchanger to speak with his/her tax advisor regarding the effects of debt relief or receiving cash for personal use.

IV. REASONS A TAXPAYER SHOULD CONSIDER A SECTION 1031 EXCHANGE

The principal advantage of a Section 1031 tax-deferred exchange is the ability to use the entire equity of a property owned by a taxpayer to acquire replacement property. Taxpayers who have held onto properties for years because of the tax consequences of selling have the freedom to move their equity into more lucrative or appropriate properties. If a taxpayer intends to continue investing in like-kind property, an exchange is usually the preferable alternative to a sale and a purchase. Reasons for a taxpayer to participate in a Section 1031 exchange are as follows:

Consolidation of Diversification of Investments:
A taxpayer who has acquired a number of properties over the years may desire to reduce the number of his or her holdings by replacing separate properties with a single property or a reduced number of properties, all having equal or greater value than the original holdings. This method of exchanging often has the effect of reducing managerial burdens associated with day-to-day emergencies, collection of rents, and maintenance of the properties.

On the other hand, a taxpayer may desire to diversify one high value investment property into two or more different properties. In this scenario, taxpayers can reallocate investments into

newer properties and/or different neighborhoods. The effect of such an exchange can include lower maintenance expenses, lower vacancy rates, and/or greater opportunity for appreciation.

Greater Cash Flow:

Many taxpayers own raw land. Raw land may be a cash drain because of tax obligations and may not generate adequate cash payments. If the taxpayer wishes to convert such property into a cash flow asset, Section 1031 can be used to avoid the tax on the gain created by a desire to put such property to a new use.

Relocation of Investment:

Taxpayers often relocate to different parts of Iowa or the United States. Relocations may be the result of a new career or business opportunity, the need for larger operation facilities, the desire to take advantage of a different state's non-taxing of income, or a retirement move. In these circumstances, investors may not want to be absentee landlords. An investment in income-producing property managed by a taxpayer can be relocated. To avoid taxes on gain from the sale of the original relinquished property, a taxpayer can take advantage of Section 1031.

"Stepped-up Basis" for Heirs:

Should a taxpayer hold investment property until death, and taxable gain has been deferred through the life of an investment(s) by utilizing Section 1031, the recognition of gain is eliminated from an income tax standpoint due to heirs receiving the property at a "stepped-up basis." In effect, heirs inherit the property with a basis equivalent to the fair market value of the property at the taxpayer's death. In this situation, heirs would not pay tax on the sale of an inherited property to the extent the sale price does not exceed the current fair market value.

Appreciation – Leverage:

Taxpayers generally invest in real estate in part because of the opportunity to leverage their investment and obtain appreciation on someone else's funds, such as an institutional lender. Taxpayers who utilize Section 1031 are able to obtain greater financing on higher value properties. This is due to Section 1031 allowing ordinarily charged capital gains tax amounts to be applied to the purchase price of the replacement property.

V. TIPS AND TRAPS

Trap – Holding Funds in Escrow, after closing, without a qualified intermediary:

In 1991, the I.R.S. issued regulations providing safe-harbor methodologies for executing Section 1031 exchanges. Under the regulations, if an exchanger utilizes the qualified intermediary safe-harbor, and complies with certain technical requirements, the transaction will qualify for Section 1031 treatment. The safe-harbors are designed to secure an exchanger's obligation to acquire replacement property after they have sold their replacement property. To further insure this obligation, the regulations prohibit an exchanger from actually or constructively receiving

relinquished property proceeds. The regulations detail how to avoid constructive receipt problems.

All too often, exchangers become aware of the tax-deferral benefits of Section 1031 after disposition of their relinquished property. Similarly, exchangers and their advisors may be confused about the mechanics of structuring an exchange. A common problem that results is the belief that an exchange can be accomplished by instructing the closing agent to hold relinquished property proceeds in escrow after closing. Such transactions will not qualify for Section 1031 treatment because the exchanger has constructively received the funds. The constructive receipt occurs because the exchanger has the unilateral right to change the escrow instructions and withdraw the funds. This is one of the most common reasons that an exchange will fail.

To avoid this potential trap, it is imperative that exchangers and/or their advisors retain the services of a qualified intermediary, execute proper exchange documentation prior to closing, and disburse funds to the qualified intermediary trust account. Failure to do so will surely result in a failed exchange and an unhappy client. Proper documentation includes a signed exchange agreement designating a qualified intermediary, a signed assignment of the purchase and sale agreement, and notice to the non-exchanging buyer that the purchase and sale agreement has been assigned to an intermediary. A trust account, in control of the qualified intermediary, must be established so that the relinquished property sale proceeds can be disbursed directly from the closing agent to the trust account.

Trap – Dealer Properties:

To qualify for Section 1031 treatment, property must be held for investment or for use in a trade or business. Generally speaking, all real property is like-kind to any other type of real property so long as it is held for investment or use in a trade or business. The I.R.S. does not permit Section 1031 treatment of property that is held for sale or as inventory. This is an important distinction.

Persons, who in their ordinary course of business, develop land for resale, or construct buildings or homes for resale, cannot utilize Section 1031. For a developer or contractor, lots and buildings are considered inventory by the I.R.S. and ordinary income taxation rates apply. The same applies for persons who purchase apartment complexes with the intention of selling them to current occupants as condominiums. The primary test is whether or not the exchanger had the intent to hold the property for investment, or for use in a trade or business, at the time the replacement property was acquired. In these instances, the I.R.S. deems the properties to have been acquired for resale. Developers and contractors are not entirely prohibited from using Section 1031, however, the properties that they do exchange must be segregated from their development or contracting businesses.

A more common instance occurs when individuals purchase homes with the intention of updating them and immediately listing them for sale at a profit. These transactions do not qualify for Section 1031 treatment as the properties are held with the intention of selling them, and not for investment purposes. To solve this problem, tax and legal professionals should advise their clients to rent such properties in order to establish an income history. By renting the

property, the exchanger will convert the property to a qualifying use, thereby allowing Section 1031 treatment at a later date.

Trap – Exchange of Property with Related Parties:

Section 1031(f) of the Internal Revenue Code provides special rules for exchanges of property between related parties. Related parties include certain business entities related to the exchanger and family members such as siblings, parents, children, and spouses. Related parties can exchange property with one another, provided each party holds the property for a minimum of two years.

When one property is exchanged for another, the basis of the replacement property is the same as that for the relinquished property. In other words, basis stays with the person. The related party rules were intended to prevent exchangers from using the gain deferral provisions of Section 1031 to effectively shift tax basis between properties owned by related parties to reduce gain on the sale of one of the properties.

There is a common misconception that an exchanger can purchase replacement property from a related party in a deferred exchange, if they sold their relinquished property to an unrelated party, and hold the replacement property for two years. The I.R.S. in Revenue Ruling 2002-83 specifically denied tax-deferral treatment to these types of exchanges.

Tip – Mixed Use Properties – The Sale of a Farm:

Many farm exchanges involve the sale of land, buildings and a personal residence. I.R.C. Section 121 provides for a gain exclusion ($250,000 or $500,000 for married persons filing jointly) on the sale or exchange of a personal residence if, during the five year period ending on the date of the sale or exchange, the property was owned and used by the taxpayer for an aggregate of two years or more.

When structuring a Section 1031 exchange, tax and legal professionals should split the personal use property from the Section 1031 property. Vacant land can be included in the taxpayer's personal residence so long as it is next to the dwelling unit and was used as a part of the personal residence. The allocation of the house and land constituting the personal residence should maximize, to a reasonable and justifiable degree, the exchanger's utilization of the Section 121 gain exclusion. This becomes important when defining in the exchange agreement what property will be exchanged pursuant to Section 1031. The exchange agreement should only list the property subject to Section 1031 treatment. Tax and legal advisers who prepare exchange agreements may find it useful to attach a map of the property distinguishing the Section 1031 property from the Section 121 property.

The preceding principal also applies to the sale of duplexes, apartment buildings, and other mixed use properties.

Tip – Condemned Properties:

When a taxpayer is considering sale of property to a governmental entity, the taxpayer should consider whether the sale qualifies for I.R.C. Section 1033 treatment instead of Section 1031 treatment. Section 1033 allows relaxed treatment for exchanges out of properties that are to be condemned.

Tip – Vacation Properties:

Whether a vacation home can be exchanged under Section 1031 is the subject of much disagreement between tax and legal professionals. There is no I.R.S. safe-harbor allowing the exchange of a vacation home.

Many nationally recognized Section 1031 experts agree, however, that if a vacation home is used minimally for personal purposes, or is rented for a significant period of time between personal uses, it will qualify for Section 1031 treatment. As a general rule, Section 280A of the Internal Revenue Code is referenced when making a determination of whether the home has been held for investment purposes. I.R.C. Section 280A permits the deductibility of losses from a vacation or second home if personal use is not greater than fourteen days, or 10% of the number of days during the year for which such dwelling unit is rented at fair market value. It is argued that this 14-day/10% rule should apply to Section 1031 exchanges.

There are situations where vacation homes clearly do not qualify for Section 1031 treatment. With patience and advanced planning, it is possible to convert a vacation home into an investment property, thus qualifying it for Section 1031 treatment. By renting the vacation home, and discontinuing or substantially reducing personal use, a taxpayer can exchange the property at a later time under Section 1031. A clear and definite history of investment income must be apparent to the I.R.S. in the event of an audit. There is no "safe" period for how long the vacation home should be rented, however, the I.R.S. seems to like two-year holding periods for other purposes.

Tip – Retirement Planning:

Just as a vacation home or residential property can be converted to investment use, investment property can be converted to personal use. The following example demonstrates this point.

Farmer Brown is 57 years old, owns 1200 acres, including his personal residence, and farms with his 35 year old son. His son will inherit the farm upon his death. Mrs. Brown tells Farmer Brown that she is tired of the bone chilling Iowa winters and she thinks it is time to buy a condominium in Miami on South Beach. Farmer Brown is not crazy about those hurricanes, but because his wife is the love of his life, he makes an appointment with their lawyer to discuss the tax ramifications of selling some of his farm land to get some cash for the purchase of the condo. Lawyer, after hearing about the latest and greatest Section 1031 strategies at the Iowa Bar Association Tax School, suggests that they sell 200 acres of farm land, use the proceeds to purchase the condo, and rent the condo to South Beach tourists. Lawyer tells the Farmer and

Mrs. Brown that after renting the condo for a few years, they can sell their personal residence and move into the condominium as their new personal residence.

Under the above scenario, Farmer and Mrs. Brown's exchange would qualify for Section 1031 treatment, and they would not pay capital gains tax on the sale of the farm land. This transaction would fail had Farmer and Mrs. Brown had an immediate intent to convert the condo to personal use. However, they had an indeterminate intent to eventually convert the condo to personal use and did actually receive income from the investment. An indeterminate intent to convert investment property to personal use should not disqualify the exchange.

Analyzing the example further, Farmer and Mrs. Brown were able to exclude up to $500,000 on the sale of their personal residence when they moved from Iowa to Miami. This brings us to another question. Upon converting the South Beach condo to personal use, could the Browns, after suffering eight hurricanes, sell it after two years and exclude up to $500,000 in gain under section 121? There are two parts to the answer. The Browns could exclude gain up to $500,000 when they sell the condo. However, due to the recent passage of HR 4520, they must hold the property for at least five years before selling it as their personal residence. A summary of HR 4520 is included at the end of this outline.

Tip – Pre and Post Exchange Financing:

To avoid all taxable gain, the replacement property must have debt, equity, and a fair market value that is greater than or equal to that of the relinquished property. If an exchanger takes cash from an exchange ("boot"), there will be tax on the cash received.

If an exchanger desires to take equity or cash from a property without paying tax, current case law supports the proposition that an exchanger can encumber the relinquished property before an exchange or replacement property after an exchange. Despite the favorable case law, it should be noted that the I.R.S. does not support the proposition that equity can be taken from relinquished property in anticipation of an exchange or from replacement property immediately following the exchange. The I.R.S does not disapprove of pre-exchange financing if it occurs in advance of a taxpayer's contemplation of an exchange, and not in anticipation of it. This is especially true if the refinancing has an independent economic significance from the exchange.

Utilizing this strategy does have some tax risk and exchangers should approach this technique cautiously.

Trap – 180 Days Does Not Always Equal 180 Days:

Closing on all replacement properties must occur at the end of the 180th day following the transfer of the relinquished property; or, the due date from the exchanger's federal tax return for the year in which the property was relinquished.

Tax and legal professionals structuring exchange transactions must be cognizant of the fact that the exchange period may not be equal to 180 days when the relinquished property closing occurs

after October 17 and before the end of the year. To receive the full 180 days the exchanger or the exchanger's advisor must file a request for an extension.

Trap – Early Release of Exchange Account Funds:

I.R.C. Section 1031 restricts an exchanger's right to receive, pledge, borrow, or otherwise obtain the benefits of money or other property before the end of the exchange period. There are a number of circumstances where an exchanger may want to receive some, all, or remaining proceeds from the exchange account prior to the end of the 180-day exchange period.

Under the I.R.S. Regulations, the exchanger cannot receive funds held by the qualified intermediary until the occurrence of one of three events. The first event is when the 45-day identification period has expired and no identification was made (or property identification was revoked before the 45th day). The second is when the exchanger identifies property within the 45 days and closes on all identified properties. The third is when the 180-day exchange period has expired.

The position of the I.R.S. is clear that if funds are released from the qualified intermediary account prior to the occurrence of one of the three above instances, the exchange will fail.

Trap –The 15% Capital Gains Tax Rate Myth:

When considering whether to execute a Section 1031 exchange, many taxpayers assume that their tax will not exceed 15 percent. The 15 percent capital gains tax rate is for gain due to appreciation. Capital gains due to depreciation is taxed at 25 percent. As an additional consideration, the State of Iowa taxes capital gains at individual income tax rates which can be up to 8.98 percent. Capital gains on property held less than one year is taxed as ordinary income. Taxpayers considering the utility of a Section 1031 exchange should be mindful of tax obligations in addition to the standard 15 percent rate for capital gains due to appreciation.

Trap – Vesting Issues:

Although not specifically addressed in the Regulations, replacement property must be acquired in the same name as title was held to the relinquished property. This rule is commonly referred to as the "same taxpayer" requirement.

This becomes an issue when a husband and wife are involved in an exchange. It is important for tax and legal professionals who are structuring exchange transactions to determine whether the husband and wife own the property jointly or individually. Confusion occurs when one spouse actually owns the property and both spouses deed the property to address the transfer of dower rights. If one spouse owns the relinquished property, that spouse only must acquire the replacement property. Upon completion of an exchange, the spouse owning the property can gift a portion of his/her interest to the non-owning spouse.

Tip – Miscellaneous Documentation Issues:

Cooperation Language:

Purchase and sale agreements should contain language securing the non-exchanging party's obligation to cooperate with a Section 1031 exchange. Occasionally, a non-exchanging buyer or seller will use the time restrictions as negotiation leverage against the exchanger. To avoid this occurrence, it is advisable for an exchanger to attach an Addendum or Amendment to the purchase and sale agreement after the price and major terms of the agreement have been negotiated. An example of cooperation language for the relinquished property follows:

> It is the intention of seller to transfer the above-listed property pursuant to Internal Revenue Code Section 1031, which sets forth the requirements for tax-deferred real estate exchanges. Seller's rights and obligations under this and future agreements will be assigned to a qualified intermediary for the purpose of completing such exchange. Buyer of the above-listed property agrees to cooperate with seller and the qualified intermediary in a manner necessary to enable seller to complete said exchange. Such cooperation shall be at no additional cost or liability to buyer.

Assignment and Notice of Assignment:

Under the qualified intermediary safe-harbor, the purchase and sale agreement must be assigned to the entity serving as qualified intermediary. Tax and legal professionals structuring exchange transactions must ensure that the purchase agreement permits assignments. Typically, purchase agreements for Iowa properties do not prohibit assignments, however, many out-of-state purchase agreements do contain such prohibitions. In these cases, the purchase agreement addendum should amend the terms of the purchase agreement to allow assignment to a qualified intermediary.

Section 1031 also requires that notice of the assignment be provided to the non-exchanging party. This is typically accomplished by having the non-exchanging buyer or seller acknowledge their receipt of the notice. The I.R.S. holds the position that if notice of the assignment is not provided, the exchange will fall outside of the safe-harbor and is at risk of being disallowed.

VI. REVERSE AND IMPROVEMENT EXCHANGE BASICS:

Exchanging taxpayers may be unable to sell relinquished property prior to acquiring replacement property or may have specific reasons to acquire replacement property prior to the sale of the relinquished property. It may additionally be the desire of an exchanger to construct improvements on a property prior to its acquisition. For these circumstances, the I.R.S. created a "safe harbor" with Rev. Proc. 2000-37 authorizing the execution of "reverse" and "improvement" exchanges.

Under this I.R.S. safe-harbor, exchangers are prohibited from taking actual title to the replacement property, prior to the sale of relinquished property. As a result, an "Exchange Accommodation Titleholder" (EAT) must step into the shoes of the exchanger. Careful attention

must be paid by the exchanger to ensure that proper arrangements have been made prior to the sale. As with a delayed exchange, specific restrictions and time limitations must be followed, including the requirement that an exchanger use a qualified intermediary to facilitate the exchange between the respective property owners and the EAT.

Fees for reverse, build-to-suit, and improvement exchanges are substantially greater than for delayed exchanges due to the fact that I.R.S. rules require that the EAT actually own the "parked" property. Certain transactional costs are inherent in the transaction and include transfer taxes, recording fees, mortgage taxes, lender charges, escrow and title fees, legal and accounting fees, insurance fees, and the costs of creating a special purpose entity (SPE) to hold the parked property.

Reverse and improvement exchanges involve complex considerations. Exchangers contemplating this course of action should take great care in planning a reverse or improvement exchange.

Tip – Strategies for Avoiding a Reverse Exchange

For some taxpayers, a reverse exchange can be a valuable tool. In a delayed exchange, exchangers often find the 45-day identification period to be too restrictive and it is sometimes difficult to locate replacement property that is suitable in terms of both price and desirability. A reverse exchange provides an exchanger with as much time as necessary to purchase a suitably priced replacement property. Upon the close of the replacement property, the exchanger has 45 days to identify the relinquished properties they wish to sell, and 180 days within which the relinquished properties must be sold. Using the reverse exchange mechanism in this manner enhances the economic efficiency of the acquisition process.

The reverse exchange mechanism is most commonly used when an exchanger intends to execute a delayed exchange and enters into a contract to purchase replacement property anticipating that the relinquished property can be sold prior to acquiring the replacement property. When the exchanger becomes unable to sell the relinquished property in time, the delayed exchange turns into a reverse exchange.

For such situations the exchanger should attempt to delay the closing on the replacement property. To delay closing, the exchanger can offer additional earnest money, a non-refundable deposit, entrance into an option agreement, a rental agreement, or a lease/option agreement. It should be noted that some of the previously listed strategies are not without some tax risk. For federal income tax purposes, property is transferred when the "benefits and burdens" of ownership are transferred. The more factors showing that the exchanger has effectively purchased the property, the more likely the I.R.S. will disallow the exchange.

-----Original Message-----
From: fea1031@earthlink.net [mailto:fea1031@earthlink.net]
Sent: Tuesday, October 26, 2004 3:34 PM
To: davebrown@iowapropertyexchange.com
Subject: FEA LEGISLATIVE UPDATE RE: HR 4520

FEA LEGISLATIVE ALERT

To: FEA Members

RE: HR 4520 - President Signs Law that Limits §1031 Exchanges Involving a Principle Residence

President Bush signed HR 4520, which is a larger corporate tax bill that contains a five-year restriction on IRC Section 1031 Like-Kind exchange involving a principle residence.

Please refer to the following summary for an up-to-date analysis on this new provision.

Five Year Hold Required to Exclude Gain Under IRC §121

On October 22, 2004, President Bush signed into law corporate and foreign tax legislation that also contained a provision affecting IRC §1031. Under this provision, a taxpayer who exchanges under IRC §1031 into a rental house as a replacement property that is later converted into their primary residence, is not allowed to exclude gain under the principal residence exclusion rules of IRC §121 unless the sale occurs at least five years from the date of its acquisition. The Conference Agreement on H.R. 4520 includes the following provision to amend §121(d):

Sec. 840. Recognition of gain from the sale of a principle residence acquired in a like-kind exchange within 5 years of sale.

(10) PROPERTY ACQUIRED IN LIKE-KIND EXCHANGE.--If a taxpayer acquired property in an exchange to which section 1031 applied, subsection (a) shall not apply to the sale or exchange of such property if it occurs during the 5-year period beginning with the date of the acquisition of such property.

The result of this additional requirement to IRC §121 is that anyone exchanging into a rental which they subsequently convert to personal use will have to wait at least five years from acquisition before they can sell it as their residence and exclude any gain under IRC§121(a).

The change to the home seller rules of IRC §121 became effective for principal residence sales occurring on or after October 22, 2004. Any taxpayer who previously acquired their current residence through a tax deferred exchange within the past three years will now have to wait at least another two years before selling their home and excluding gain. This assumes they meet the two out of five year occupancy test.

Example: A taxpayer sold their rental house two years ago, completed a simultaneous exchange, and moved there last month to occupy it as their principal residence. Under the new law, they will have to wait three years before selling the property and excluding gain under IRC §121.