MAINE BROKERAGE

By Steve Baumann, The Boulos Company

Thinking and planning your way through the three party tax deferred exchange

Those of us who regularly deal with IRC Section 1030 Tax Deferred Exchanges know the general rules well enough so that we can successfully work with our clients and their tax advisors and efficiently complete these transactions. We know, for example, that:

- The properties exchanged must qualify as "like kind" and must be "held for productive use in a business or for investment."
- After transferring the "relinquished property" our client must identify the replacement property within 45 days and must
- Receive the "replacement property" within 120 days or if earlier, by the due date of his or her Federal income tax return for the year of sale.

All the above is not generally thought of as "rocket science". For example, we know that it is generally difficult to blow the "like kind" test, as most exchanges of real estate qualify as like kind exchanges, including exchanges of residential for commercial properties, real estate for unimproved land, commercial for residential real estate and vice versa. We know, also that the 45 and 120 day requirements are mechanical and must be met, and so we regularly plan our client's replacement selection process to work within these time constraints. We know, also that our client must not be allowed to actually or constructively receive cash and then use the proceeds to buy the replacement properties. To meet this constraint, we generally recommend that our client engage a qualified intermediary as an exchange accomodator to close the sale of the relinquished property; receive the buyer's consideration; apply this consideration to the purchase of the replacement property; close the acquisition of the replacement property; and finally, arrange for the transfer of title to the "seller."

So where is the thinking (and the planning) important?

First, the risk obviously exists that given the time constraints associated with the 45 and 120 day rules our client, if he or she does not utilize our services to preplan to meet these requirements by beginning the selection process as early as possible, may well overpay for the replacement property. Recognizing (a) that the tax deferral comes at a price because the step up in tax basis of the replacement property can only be achieved if the purchase price of the replacement property exceeds the net selling price of the relinquished property and (b) the net tax deferral including state income taxes usually does not exceed say, 30 percentage points, overpaying say, 10% will eat significantly into the tax savings.

Second, often to maximize the net selling price, we have seen situations where the seller is motivated to take back a note from the buyer for a portion of the selling price. Receipt of the buyer's note by the exchange accomodator does not immediately result in additional taxes. However, the ultimate distribution of the note by the accomodator to the seller does create a problem, as it constitutes "boot" and results in "taxable gain" equal to the lesser of the principal balance of the note or the tax deferred gain. If the client uses the cash method of accounting for tax purposes the receipt of the note does not immediately result in additional tax, because the installment method can be used to defer the tax until payments are received on the note. Alternatively, depending on the credit quality of the note, the accomodator possibly can apply the note as part of the downpayment on the replacement property or can discount the note with the seller's bank using the cash received as part of the downpayment. Depending on the seller's financial resources, he or she could always purchase the note from the accomodator.

Third, recently we have seen a situation where the seller desired to swap into an expensive Manhattan area condo. Since, the tax deferred exchange rules require that the exchanged properties constitute "property used in the business" or "held for investment," a "swap" into a residential condo will not meet the tax deferral requirements, if the condo is to be used for residential purposes. If however, the condo can be leased to a third-party lessee for say, at least a year, it could qualify as "property held for investment" and could qualify for tax deferred treatment.

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