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1031-Exchange Investors Earn the IRS's Blessing

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By **RAY A. SMITH**

Staff Reporter of The Wall Street Journal

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Take note, 1031-exchange investors: The IRS is about to give its seal of approval on your transactions. But you'll have to play by a lot more rules.

The Treasury Department has never felt entirely comfortable with 1031 exchanges, which it almost recently classified as an abusive tax-avoidance mechanism. Under 1031 transactions, real-estate owners defer capital-gains taxes on the sale of property by turning around and purchasing a similar type of property. The Treasury Department's uneasiness with the transactions has made some investors nervous as to whether the IRS could later find fault with the exchanges they conducted. Investors have continued to conduct exchanges, but never with the assurance that the IRS wouldn't come back to challenge them after the fact.

Soon, though, investors will have more assurance. The Treasury Department is planning changes to the form that investors must fill out with every 1031 transaction. The changes would require additional disclosure material, such as a list of potential replacement properties that were considered and identification of the party that purchases the disposed property.

The Treasury Department says the proposed changes to Form 8824 are designed to make sure 1031 exchanges are being properly reported, especially exchanges involving so-called related parties, which are prohibited under some circumstances. Related-party exchanges are those among relatives, business partners or companies that are part of the same entity.

A number of tax attorneys and exchange-industry professionals say the moves should help exchange investors in terms of clarifying what is allowed and what isn't.

"It helps the taxpayers better comply with the rules," says Stephen M. Renna, senior vice president and counsel at the Real Estate Roundtable, a Washington, D.C.-based lobbying group that helped work on the form's recommended changes. "Taxpayers will be asking themselves [when they see the questions]: 'Is that a fact of my transaction?' It helps taxpayers with their own compliance and helps the IRS in terms of compliance with the rules."

The Treasury Department is still working on the amendments to the form and hasn't set a date for the form to be ready, says Tara Bradshaw, a spokeswoman for the department.

With the 1031 transactions, also known as like-kind exchanges, the new property the seller wants to buy has to be identified within 45 calendar days of the sale of the first property and purchased within 180 days. In most cases, an independent third-party intermediary prepares the exchange and handles the money.

The proposed changes to Form 8824 came about following the Treasury Department's release in February of final regulations to crack down on abusive tax-avoidance transactions. At the urging of the Real Estate Roundtable and members of the American Bar Association's tax section, the Treasury Department decided that 1031 exchanges would be excluded from being defined as tax shelters so long as a form 8824 is filed.

But the department did so with some reservations. "The Treasury Department was still concerned about the potential abuses [of 1031 exchanges], particularly abuses related to identification and abuses related to related-party exchanges," says Louis S. Weller, a principal at Deloitte & Touche LLP's national real-estate tax services group in San Francisco, who was involved in the discussions.

Mr. Weller, working on behalf of the Real Estate Roundtable, created ideas that were submitted to the Treasury Department by the roundtable. Members of the American Bar Association's tax section submitted similar ideas on how to modify the form.

"For taxpayers that are following the rules and doing [1031 exchanges] correctly, they will have some assurance that if they get audited, they won't have any problems" in terms of identification of the exchange party or property, says Mary Foster, an attorney with the American Bar Association's tax section.