

For Information Purposes Only – Not a Tax, Accounting or Legal Opinion or Definition – Consult your Real Estate Tax Accounting and/or Legal Professionals before initiating a Tax Deferred Exchange

1031 Exchange Planning – Multiple Property Exchanges

Consolidation and Diversification Exchanges*

(The scope of this discussion is limited to a discussion of strategies for Forward 1031 Exchanges, other considerations may apply to Reverse 1031 Exchanges.)

Multiple Property Exchanges

Multiple property exchanges take many forms including one or more properties sold in **the same exchange** into one or more replacement properties, or one or more properties sold **in separate exchanges** into one or more replacement properties. There are advantages and disadvantages to each approach. You should always consult your tax and legal advisor before implementing these complex exchange strategies.

What are Consolidation and Diversification Exchanges?

As the name implies, a Consolidation Exchange is considered when an investor has diverse, appreciated real estate holdings and wishes to consolidate them, using Section 1031, for any of the following reasons:

- To aggregate gains and defer current taxation up to 100%
- To move from several appreciated properties into one or more cash flow property(ies) when it appears that appreciation has topped out (or at the beginning of an “up” real estate cycle, to move from cash flow to appreciation for leveraged gain)
- To simplify control and management
- To focus on a specific geographic area
- To consolidate gains into a very desirable property

A Diversification Exchange can be used when the appreciation of the real estate portfolio of an individual investor has reached a point where the investor feels that:

- Appreciation of individual properties have topped out in a given market for the current real estate cycle and the investor wants to realize the gain through Section 1031
- An investor has a concentration of properties in a geographic area that may have economic or other conditions that will not support continued price appreciation or that may affect rentals to the downside where the properties are held for cash flow
- The taxpayer wishes to sell individual units of property in stages to realize incremental portions of the original gain (these could be planned future sales)

What limitations apply to multiple property exchanges?

The basic problem when multiple relinquished properties are exchanged for one or more replacement properties is that the timeline is the same as for a “one for one” exchange and the number of properties that may be identified is the same as in a “one for one” exchange.

The 180 day time clock starts running the day the first relinquished property sells and if the “Three Property Rule” is elected to identify replacement properties, **only three** properties may be identified under the rule for all relinquished properties, **not three for each**.

The most crucial date is the **“key date”** (sometimes called the Initial Transfer Date or ITD). The **“key date”** is **the closing date of the first property relinquished (sold) in a forward exchange, whether the goal is either Diversification or Consolidation**. By midnight, forty-five days from that date, there must be a formal identification of the choices for the replacement property(ies).

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Exchanges that occur after Mid-October of each year may require the taxpayer to file an “On-Time Extension” in order to take advantage of the full 180 calendar day window, further complicating the exchange.

More importantly, in a Consolidation Exchange, the proceeds that may be applied to the targeted replacement property must be obtained from relinquished properties that close within the timeline of the first property relinquished, which determines the “**key date**”.

If a relinquished property does not close in that timeline, the funds obtained cannot be applied to the targeted replacement property and may be taxable especially if they cannot be applied to a replacement property targeted for that contingency in the same exchange.

To reiterate: When multiple properties are included in the same exchange, the 45 day and 180 timelines for all exchange properties are affected by the date the first property is relinquished (both start on that “**key date**”) selecting the optimal replacement property can be difficult, since who knows exactly when each additional relinquished property will actually close?

As a rule of thumb, you may want to stage the sales of relinquished properties to start with the property that has the most gain. By doing this, you can preserve the most tax deferral in the exchange, in case any of your other relinquished properties do not close within the “**key date**” timeline that governs the entire exchange. Remember that the targeted replacement properties must equal or exceed the value of the relinquished property(ies) and the mortgage debt on the replacement property(ies) must be the same as the mortgage debt carried on the relinquished property, unless you bring cash in from outside the exchange to reduce the size of new mortgage obtained.

When separate exchanges for each relinquished property are used for Consolidation into one property: The identification statement from each separate exchange should identify the appropriate fractional interest that can be purchased with the proceeds of each exchange. You really should use a CPA to calculate verify the numbers in these types of exchanges. The separate exchange arrangements should be acknowledged in all of your sale, escrow, title and financing arrangements for each property.

There are a couple of techniques that multiple property exchangers can use to maximize the results of selling exchange properties.

1. Delay the closing on the first relinquished property, to allow time for the sale of the rest of the relinquished properties to be agreed to and closed within the “key date” timeline. Some exchange sellers allow buyers to occupy the property before the closing date on a triple net “NNN” lease with the closing date at the option of the exchanger selling the property.
2. The exchanger can use an “option to purchase” to control the replacement property until all or most of the exchange properties are negotiated and closings can be timed close together.
3. Try to arrange sales of relinquished properties so that the closing dates occur within the 45 day Identification Period.

A Consolidation Exchange can fail if all of the funds required for the purchase of the targeted replacement property cannot be obtained from targeted relinquished property(ies) due to timing of the various closings. In that case, an investor may be required to bring cash into the exchange to preserve the available tax deferral and/or consummate the transaction (with potential for at least a partial deferral of taxation). Prior to the exchange a source of cash should be identified for this contingency. In some cases it may make sense to sell property(ies) outright and pay taxes on the gains to obtain cash for potential contingencies. In some situations, a taxpayer may have to sacrifice the exchange, and this will mean taxable gains to the investor.

Replacement Property Identification

In a Diversification exchange the exchanger can use any of the codified rules to identify exchange properties. The overall tax deferral that results from the exchange will be determined by the actual number and value of the properties identified and closed within the “key date” timeline.

Many Diversification Exchanges start out with the goal of obtaining the “maximum value” replacement property, with the most leverage. This goal may be impossible to achieve when sales and proceeds from relinquished properties are not obtained within the exchange timeline and/or when targeted properties do not close for any reason.

Exchangers face the challenge of matching the values of replacement properties to the values of multiple relinquished properties which may or may not close in the required time period. One way to moderate this issue is to make sure that the most appreciated/highest value property sells first and base the value of targeted property(ies) on the value of that sale to be certain that the target property can be obtained if only the first relinquished property sells in the exchange timeframe.

Another potential concern results from waiting to sell (or being forced to sell) in a market with a downward trend in prices would result in lower gains, which could affect the viability and size of your replacement purchase(s). Since you can only use funds from properties that close within 180 days of the “key date” of the first relinquished property, if subsequent relinquished properties do not close in the proper timeframe, the proceeds cannot be applied to the desired replacement property. This fact argues for the use of multiple exchanges when diversifying, to improve the flexibility of identifications and the overall timeline. The cost of multiple exchanges is not generally a factor in planning, since the tax deferral value in the exchanges far exceeds exchange costs. If it does not, why are you considering an exchange?

With any investment strategy, your individual results may vary for a variety of reasons. In any 1031 exchange involving multiple properties, it is possible that you may end up with some tax liability on one or more relinquished properties, simply because it may be impossible to exactly match the timing of sales to the overall 1031 Exchange timeline for either Diversification or Consolidation purposes.

If you are attempting to use maximum leverage in your exchange and do not have the required proceeds from relinquished properties, you can add funds from outside the exchange to complete the transaction, but those funds need to be liquid and immediately available to the exchange. As an investor, you will need to balance the objectives of the sale/1031 exchange with potential tax liabilities. Your tax professional can help to assess your liabilities and you should do a thorough analysis of all targeted replacement properties using various parameters to simulate different percentages of down payments and various target values.

**Both Consolidation and Diversification exchanges follow the same rules as a “one for one” 1031 Exchange, but there are accounting considerations related to the allocation of “sales price” and “substituted basis” to the replacement properties. Advance planning for these types of exchanges is critical. Your CPA should be involved from the onset of these types of exchanges to maximize the accounting side of your transactions. If your CPA or other professional is not familiar with Section 1031, have them contact your Qualified Intermediary (QI) directly. While your QI is constrained from giving tax, legal or investment advice directly to you (as an Exchanger), with your permission, they can and do work closely with your team of tax, legal and investment professionals to structure the best possible exchange for your circumstances.*