

Using The Reverse Starker

by Benny L. Kass

Q: We have investment property (a single family house) which we have rented out for a number of years. We have found another property that we would like to rent out for a couple of years and then ultimately move into it as our principle residence. Our current investment is on the market, but we have not been able to sell it yet. Is there any way that we can purchase the new property and still have it treated as a Starker exchange?

A: Yes, because the Internal Revenue Service has authorized what is known as a "reverse Starker".

This is a very complicated area of tax law, but it can impact on a large number of real estate investors throughout this country. So let's first get to the basics.

There is a section of law in the Internal Revenue Code (section 1031) which states that if you exchange one investment property for another -- and you strictly follow the rules -- there is no gain on the disposition of the property you previously owned. Since terminology is important, the property you sell (exchange) is called the "relinquished property" and the new property you acquire is called the "replacement property."

Since it is almost impossible to find and accomplish a simultaneous exchange (I give you Blackacre and in exchange you give me Whiteacre), the Courts -- and Congress -- have authorized what is known as a "Starker Exchange." This was named after a man by the name of Starker who sold his property, put all the proceeds in escrow, and then at a later date had the escrow agent purchase the replacement property. The Supreme Court held that this qualified as a 1031 Like-Kind exchange and Mr. Starker -- who had made a sizable capital gain on his relinquished property -- did not have to pay capital gains tax.

Congress did not like the open-endedness of this arrangement, and put a tight timetable on the Starker (non-simultaneous) exchange. Once the replacement property was sold, the proceeds had to be held by an independent escrow agent -- called a "qualified intermediary." The taxpayer had to identify the replacement property (or properties) within 45 days from the sale of the relinquished property and had to actually take title to that property within 180 days from the sale.

In 1991, the IRS issued comprehensive regulations spelling out how the deferred exchange would work. However, in a preamble to those regulations, the IRS made it clear that although they were studying the reverse Starker, the 1991 regulations specifically did not apply to those situations where the replacement property is acquired before the relinquished property is transferred.

The 1991 regulations opened the door for a great number of 1031 transactions. Investors who had made a lot of profit on the market value appreciation, and who otherwise would have to pay a lot of capital gains tax -- it was at a rate of 28 percent in those days -- could now sell the property, go through the legal and technical formalities of a Like-Kind exchange, and ultimately have the replacement property without having to pay any capital gains tax.

It must be noted that the IRS is not giving the taxpayers a free ride. The tax basis of the relinquished property becomes the basis of the replacement property. For example, if you had made \$100,000 profit on the sale of the relinquished property and purchased the replacement property for \$200,000, in effect your basis was only \$100,000. Thus, when you sell the replacement property -- and engage in no further tax-deferred arrangements -- you will ultimately have to pay tax on the total profit you have made. That is why it is a misnomer to call a 1031 exchange a "tax free" transaction; the real terminology is a "tax-deferred" transaction.

Taxpayers began to realize that it often was difficult -- if not impossible -- to locate replacement property within 45 days or actually take title within the 180 days. Like your current situation, you have found a property you would like to acquire but under the IRS regulations, you had to sell the relinquished home first. Taxpayers could not take a chance that the relinquished house would sell on a timely basis, and if they missed the deadlines, would be out of luck and have to pay the capital gains tax.

However, this was all resolved by the IRS issued new regulations, effective September 15, 2000, authorizing the so-called "**reverse starker**". You can now arrange to buy a replacement property before you sell your relinquished property, and will still be able to defer any capital gain you have made on the sale of that property.

The new regulations provide specific guidelines on how to accomplish a reverse-Starker exchange. They are complicated, and you must consult your legal and tax advisors before embarking on the 1031 route. Here are some highlights of the new regulations:

- A taxpayer can arrange for the replacement property to be held in a "qualified exchange accommodation arrangement." In government language, this will now be called "QEAA."
- Qualified indicia of ownership of the property by the QEAA is required. This means that the QEAA must either have legal title to the replacement property or other some other arrangement that is acceptable to the IRS to demonstrate ownership. A land sales contract (also called "contract for deed") will also suffice. Under this latter arrangement, the QEAA will not have actual legal title, but will have certain obligations under a contract. This will avoid having to pay a double recordation-transfer tax, when the property is first transferred to the QEAA and then to the ultimate taxpayer.
- No later than five business days after the property is transferred to the QEAA, the taxpayer and the exchange accommodation titleholder must enter into a written agreement which provides that the latter is holding the property for the benefit of the taxpayer in order to facilitate an exchange under section 1031.
- Both the taxpayer and the exchange accommodation titleholder (the QEAA) must report the federal income tax attributes of the property on their own federal income tax returns.
- No later than 45 days after the replacement property is transferred, the taxpayer must identify the relinquished property. The IRS allows the taxpayer to identify alternative and multiple properties, and if you have more than one investment property this gives the taxpayer some flexibility as to which property will be sold.
- No later than 180 days after the replacement property is transferred, it must be conveyed to the taxpayer.
- Perhaps the most important aspect of the new reverse Starker regulations is the requirement that the taxpayer have a bona fide intent to engage in a 1031 exchange.

According to the new regulations:

At the time the qualified indicia of ownership of the property is transferred to the exchange accommodation titleholder, it is the taxpayer's bona fide intent that the property held by the exchange accommodation titleholder represents ... replacement property ... in an exchange

that is intended to qualify for non-recognition of gain (in whole or in part) or loss under §1031.

This is, indeed, a very complicated area of real estate law. But it does provide one method of deferring the gains made on investment property.

You have also highlighted a very interesting loophole in the law. You want to obtain the replacement property, use it for a couple of years as an investment, and then move into it. Let's look further at this example. Many years ago, you purchased a house for \$50,000. You lived in it for several years, but when your family grew, you moved out and started to rent the property. It has been rented since that time. You have made no improvements and it is now worth \$500,000.

If you were to sell the property, without engaging in a Starker exchange, your gain (excluding real estate commissions and closing costs for this discussion) would be \$450,000. Your federal tax consequences at the current 20 percent rate would be \$90,000 ($\$500,000 - \$50,000 \times 20\%$).

Instead of paying this tax, you engage in a 1031 exchange -- either a regular or a reverse Starker. There is no magic formula for how long you have to keep this property rental; the consensus among tax experts is that you should keep the property rented for at least one full year.

After the year is over, you decide to move into the home and treat it as your principal residence. Under other provisions of the tax laws, if you live in this property for at least two years, you can exclude up to \$500,000 of the gain (or \$250,000 if you are not married or file a separate tax return).

Thus, let's say you eventually want to retire to Florida. You enter into a Starker (or reverse) exchange with your current property and obtain the replacement property down South. Rent it out for at least one year, and then move into it as your principal residence. As long as you play by all of the rules, you may be able to shelter all (or a good portion) of that \$90,000 tax which otherwise would have to be paid.

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