Distressed Property Acquisitions in 1031 Exchanges

Acquisition of discounted investment property through: (i) a foreclosure auction, (ii) a bank's sale of bank owned property ("REO property"), or (iii) a short sale may present a great buying opportunity in today's real estate market, but these transactions present unique challenges that should be thought through well in advance of the acquisition if the acquisition is intended to complete a tax deferred exchange through your qualified intermediary ("QI").

The Deferred Exchange Process

Under Treasury Regulations governing tax deferred exchanges, a QI must do the following to facilitate a deferred exchange:

Step 1: acquire the relinquished property from the exchanger and transfer the relinquished property to a third party buyer;

Step 2: receive and hold the proceeds from the relinquished property sale;

Step 3: advance the proceeds held for the exchange to purchase replacement property from a third party seller; and

Step 4: transfer the replacement property to the exchanger to complete the tax deferred exchange.

(Note that the above process is reduced to discreet steps for purposes of this discussion only and does not include all aspects of a successful tax deferred exchange.)

Sequential Deeding

Prior to the Treasury's issuance of Revenue Ruling 90-34 and subsequent regulations under section 1031, the QI actually received a deed and took title to the relinquished property in Step 1 above. Similarly, the QI received title to the replacement property from the seller in Step 3 and conveyed title to the exchanger as described in Step 4. In the business, this process is referred to as "sequential deeding." The need for the QI to step into title as part of the sequential deeding process was cumbersome insofar as the QI's transitory ownership complicated the issuance of title insurance, involved duplication of transfer taxes and introduced transactional risks for the QI associated with its ownership of both the relinquished property and the replacement property.

Direct Deeding

The Treasury Regulations introduced in 1990, however, streamlined the process by permitting a new process called "direct deeding." Under the direct deeding regime, the QI merely takes an assignment of a written contract of sale in Step 1 and delivers a written notice to the buyer that the QI is acting as the intermediary for the seller in a tax deferred exchange. Having taken those steps, the Regulations permit the QI to direct a deed from the exchange client to the relinquished property buyer.

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On the replacement property acquisition, the QI uses the same process in reverse. The QI takes assignment of the replacement property purchase contract that was negotiated and executed by the exchange client, notifies the seller of the replacement property that the QI is acting as intermediary, advances the exchange proceeds to the purchase and directs the parties to deliver a deed from the seller to the exchange client. For this process to work smoothly, the purchase agreement should include exchange cooperation language and should permit assignment to the QI for purposes of the 1031 exchange (See the link to Exchange Cooperation Language).

Since the direct deeding process avoids the complications and expenses associated with sequential deeding, all professional qualified intermediaries use direct deeding as a matter of course, but direct deeding will not be available unless there is a written purchase contract that can be assigned to the qualified intermediary to facilitate the exchange. As it turns out, this little requirement can pose a problem if replacement property is acquired through a foreclosure auction, REO property sale, or a short sale.

Acquisitions of Foreclosure Property

As a general rule, there is usually no contract to acquire property through a foreclosure auction. As such, the intermediary may need to acquire the replacement property by actually bidding in the auction and taking title to the foreclosed property. These transactional steps may introduce increased transaction fees and present mechanical issues relating to who will actually bid for the QI at the auction, how payment of the auction price must be paid and the timing of that payment. Careful consideration of these issues should be done long before the expiration of the 45 day identification in the exchange transaction. A thorough understanding of the auction rules in the jurisdiction and an agreement with your QI that addresses the auction requirements is a must if you intend to acquire foreclosure property in your exchange.

Acquisitions of Short Sale and REO Property

Although there is usually a written purchase contract negotiated and executed in a bank's sale of REO property and in the case of a short sale, the bank may not permit the inclusion of exchange cooperation or other assignment language in the purchase contract if the issue first arises after the contract has been approved by senior bank management. Accordingly, you should make sure that the REO or short sale purchase contract contains the necessary assignment and exchange cooperation language. If that cannot be accomplished, then the QI may need to step in to execute the contract and acquire title to the replacement property. Direct deeding will not be available without an assignable purchase contract. Again, these issues should be carefully considered before the expiration of the 45 day identification period expires e.g., before the property is identified as a potential replacement property). As noted above, those issues should be discussed with your QI early in the exchange and well before the expiration of the identification period.

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