# Save Tax Dollars With a Section 1031 Exchange

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## Introduction

The use of tax-deferred exchanges of taxpayers' property continues to increase as realtors, attorneys and accountants become more aware of the benefits of Internal Revenue Code (I.R.C.) Section 1031 Exchanges.

Even those people regularly involved in 1031 exchanges may be confused regarding the proper methodology for structuring exchanges. It is also important to remain informed on some of the new developments in the exchange business. The purpose of this article is to outline some of the basic exchange concepts and update you on some new ideas in the exchange industry.

## The Ground Rules

To qualify for tax deferment under I.R.C. Section 1031, the taxpayer must exchange property held for productive use in a business or trade, or held for investment for a "like kind" property also to be held for productive use in business or trade or held for investment purposes. An exchange can be a simple swap of property, a simultaneous exchange or a delayed exchange. With court cases and the IRS regulations now in place, it really does not make much sense to structure an exchange using multiple parties as was done before the changes in the law.

The Starker decision in 1979 was the landmark case, which established the basis for delayed exchanges (T.J. Starker vs. U.S., 432 F. Supp 864 (D. OR. 1977) aff'd, rev'd & rem'd 602 F. 2d 1341 (9th Cir., 1979).) The taxpayer, Starker, exchanged title to his property for a contractual promise by the buyer, Crown-Zellerbach, to acquire like-kind property to be selected and designated by Starker at a later date. No cash was paid at the time of Starker's conveyance to Crown-Zellerbach. Starker's net sale proceeds were held by the buyer as a "net exchange value" credit on its books. Starker later selected properties using his credit toward the acquisition price. Crown-Zellerbach acquired the properties and immediately transferred the title to Starker. This delayed exchange transaction set the precedent for completing 1031 exchanges on a delayed basis.

The IRS amended the regulations for exchanges generally in 1991. The regulators clarified the case law for exchanges including the issues of identification and receipt of replacement property and "safe Harbors" for avoiding actual and constructive receipt of cash or other non-qualifying property. Under the most recent regulations, it is easier to structure an exchange acceptable to the IRS while providing the taxpayer some security for the exchange funds held during the course of the transaction. The regulations also helped resolve some taxpayer uncertainty about exchanges in general. To qualify for tax deferral, the taxpayer must trade or exchange his or her Section 1031 property for like-kind Section 1031 property following the terms of an integrated plan (exchange agreement) structured to effect the exchange of like-kind properties. An agreement to sell and a subsequent purchase do not qualify as an exchange agreement. The taxpayer may enter into an agreement to exchange with either (a) the Seller of the replacement property, (b) the Buyer of the replacement property, or (c) a qualified exchange intermediary. Since individuals are subject to liens, judgments, incapacity or vacations, the taxpayer is well advised to seek the assistance of a professional exchange intermediary to facilitate the exchange. Most professional intermediary companies will provide the exchange agreement and other exchange documentation, and will oversee the closing, reviewing closing instructions and settlement statements.

## The Exchange Agreement

The exchange agreement should set forth clearly and concisely the intentions of the parties. The agreement should clearly provide for retention of exchange funds by the qualified intermediary. It should also describe the limited circumstances under which the taxpayer may terminate the exchange and receive the exchange proceeds. If the taxpayer has the right to demand cash in lieu of property during the exchange period, after the closing on the relinquished property, the agreement appears more like a taxable sale transaction than an exchange of property, and may create problems for the taxpayer. A well-drafted exchange agreement can eliminate or at least reduce potential problems with an exchange.

## Replacement Property

The taxpayer must identify the replacement property within 45 days of the date of closing on the relinquished property. The taxpayer may identify up to three replacement properties without limitations on value. The taxpayer may also identify any number of replacement properties if their aggregate value does not exceed 200% of the aggregate value of all relinquished property. A party to the exchange (i.e., the intermediary or the qualified escrow holder) must receive the written identification form, or "designation form," not later than the 45th day of the exchange. There is no grace period.

In addition to properly identifying the replacement property, and staying within the limited number of properties, the taxpayer must acquire the title to the replacement property the sooner of (1) his or her tax filing date, or (2) 180 calendar days from the date in which the relinquished property was transferred (tax filing extensions not with-standing). There is no grace period for these deadlines unless the taxpayer is adversely affected by a presidentially declared disaster.

## Danger Zones

Problem areas in exchanges have always been "constructive receipt" or "actual receipt" of cash or other non-qualifying property, "disqualified person" issues and "related party" issues.

Simply put, the taxpayer cannot receive cash from the exchange, have the right to receive cash (including the interest or "growth factor"), or have control over the exchange funds, directly or indirectly, during the course of the exchange without creating a taxable event or disqualifying the exchange. The actions taken during the course of the exchange must coincide with the taxpayer's intent. The taxpayer is in constructive receipt of the exchange funds if they even indirectly "enjoy the benefit of" the funds. These issues are more specifically addressed in the "safe harbors" discussion contained in the current regulations.

"Safe harbors" include a "qualified intermediary," "qualified escrow accounts or trusts," or "qualified security or guarantee arrangements." The taxpayer will not be considered to be in constructive receipt of cash or replacement property if the transaction utilizes these safe harbors. The taxpayer should refer to the regulations or an expert for further clarification.

The qualified intermediary must acquire both the relinquished property and the replacement property. The intermediary acquiring title to the property or accepting an assignment of contractual rights, notifying all of the parties prior to the transfer date, and causing the direct delivery of the property, can satisfy this requirement.

Final regulations also address who can act as the exchange intermediary. A "disqualified person" is anyone who acted as the taxpayer's attorney, employee, accountant, investment banker or broker, or real estate agent or broker within two years of the disposition of the relinquished property. Persons with a relationship to the taxpayer within the definitions of I.R.C. Section 267(b) and 707(b) are also disqualified. If a disqualified person acts as the intermediary, the entire exchange may be jeopardized.

Another problem is transactions between "related parties" as more fully defined in Section 1031(f). Related parties are spouses, some immediate family members and those persons or entities listed in

Sections 267(b) and 707(b). Anytime there is an exchange between related parties and one of the related parties "cashes out" within two years there is a possibility the exchange will be disallowed.

## Getting the Boot

Another important issue covered in the regulations is the taxpayer's receipt of cash or other non-qualifying property, or "boot." "Boot" is cash or other property the taxpayer receives which does not qualify for non-recognition of gain. Mortgages or other liabilities attached to property transferred in an exchange can also be "boot." The taxpayer can receive cash boot — although caution should be exercised when making it available — and the regulations provide examples of how to treat boot.

## Recent Developments

There have been a number of recent developments, which are of some interest to taxpayers. Those involve exchanges of conservation easements, water rights, timber rights and wetland mitigation credits.

With regard to conservation easements, some conservation groups and state agencies are now offering to purchase conservation easements on ranch, farm and other land. These offerings are especially attractive to landowners who can grant the easement on unproductive land, generating cash to acquire more productive property to enhance their ranching or farming operations. The Internal Revenue Service (IRS) issued Private Letter Ruling (PLR) No. 9621012 on February 16, 1996. In the ruling the IRS determined that a perpetual scenic conservation easement on ranch land was "like kind" with timberland, farmland and ranch land. In that instance, the state in which the property was located recognized the scenic conservation easement as a real property right and, therefore it was "like kind" with other real property interest.

Keep in mind that PLR's are specific to the situation addressed in the request for letter ruling and are not binding in other situations. Even though the letter ruling is not controlling with regard to other transactions, but may be a good indication of how the IRS may look at a similar situation involving the exchange of a conservation easement for other land held for investment purposes or productive use in the trade or business.

In PLR No. 9612009, which was issued December 18, 1995, the IRS determined that mitigation credits for restoring wetland property could be exchanged utilizing Section 1031 for other mitigation credits.

Water rights are another potential basis for exchange. In many states, water rights are treated as real property interests. Increasingly, ranchers and farmers have conveyed or leased water rights and that trend will probably increase. In those states where water rights are classified as real property interests, the conveyance or long term leasing of water rights could be utilized for the purposes of effecting a 1031 exchange into other "like kind" investment or income producing property.

With regard to timber rights, there have been an increasing number of farmers and ranchers who own timber property and entered into timber sale contracts with various logging companies. They have attempted to use those sale proceeds to acquire properties in a Section 1031 exchange. Unfortunately, the Internal Revenue Service has relied upon a 1953 tax court case, known as the Oregon Lumber Company Case, in disallowing those transactions as exchanges. In TAM No. 9525002, the IRS disallowed the sale of timber as part of a Section 1031 exchange. However, timber rights, much like water rights or mineral rights, are classified as real property interests in many states. Properly structured, the conveyance of timber rights should be the basis for an exchange into other "like kind" property. Use of real estate professionals who know how to structure these exchanges can result in an exchange acceptable to the IRS or at least the Tax Court.

## Gray Areas

"Parking arrangements" and "construction to suit exchanges" have increased in the past few years as more and more real estate professionals become acquainted with the benefits of utilizing those

transactions to effect exchanges for their clients. Pure “reverse exchanges” have never been approved by the Internal Revenue Service and are not included in Section 1031.

A pure “reverse exchange” is simply a situation when the taxpayer acquires the replacement property before they divest themselves of the relinquished property. However, taxpayers have been successful in entering into an a qualified exchange accommodation agreement with an exchange accommodation titleholder who acquires a replacement property and holds that replacement property for a period of time until the taxpayer is successful in entering into an agreement to exchange out of the relinquished property. Once the relinquished property transaction is closed, the taxpayer can then proceed to close the transaction for the acquisition of the replacement property using a qualified intermediary.

The structure for what is commonly referred to as a “safe harbor reverse exchange” is set forth-in Revenue Procedure 2000-37which was issued September 15, 2000. (the “Rev. Proc.”)
These “parking arrangements,” especially those outside the 180 day “safe harbor” of the Rev. Proc. can be tricky, but as long as the real estate professionals involved know some of the pitfalls, those pitfalls can hopefully be avoided, and the transaction successfully concluded.

“Construction to suit exchanges” are increasingly utilized where the taxpayer has been able to exchange out of the relinquished property but is unable to find a replacement property, which is suitable for their purposes. The taxpayer can find the raw land, but requires certain improvements to be constructed on the replacement property as part of the exchange. In those situations, it is possible to enter into an agreement with the seller of the replacement property, a developer or the exchange accommodator to construct the improvements on the property prior to the closing on the replacement property. When the improvements are complete, the taxpayer then closes on the replacement property to complete the exchange. Great care must be taken in structuring these construction to suit exchanges to avoid the agency or related party issues discussed above. Special care must also be taken to insure that the construction process can be completed within the 180-day exchange period. That can be tricky, especially in the Rocky Mountain region and other areas where the building season is shortened by adverse weather conditions and problems with material shortages. In these instances, some taxpayers may elect to utilize parking arrangements, which are structured out of the “safe harbor” of the Rev. Proc. These “non-safe harbor” parking arrangements can be successfully completed provided they are done properly. Again, the help of qualified real estate professionals, including professional exchange accommodators, can be very helpful in making sure that a construction to suit exchange or non-safe harbor parking arrangement is successfully completed.

## Summary

Tax deferred exchanges under Section 1031 continue to be a sensible and cost effective way of deferring tax on capital gains. Because the tax code is amended form time-to-time and new regulations adopted, taxpayers should discuss their impending exchanges with a professional, qualified exchange intermediary and accountant and attorney. Intermediary’s fees vary, but the taxpayer should not be afraid to ask about them up front. If the taxpayer desires to continue reinvesting in property without paying taxes, he or she will certainly value suggestions from a knowledgeable exchange intermediary about how exchange transactions are structured.

To find a good qualified intermediary, check with real estate professionals for someone they have used and recommend. A taxpayer can also check the Yellow Pages in larger cities or contact the Federation of Exchange Accommodators at 215-564-3484.

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