August 24, 2011

Section 1031: Traps for the Unwary

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Section 1031 of the Internal Revenue Code provides an exception to the general rule that gain or loss must be realized upon the sale or exchange of property. In general, this provision enables a taxpayer to exchange property for other property of a "like kind" in a tax-free transaction. Sounds easy enough, right? Unfortunately for taxpayers, there are numerous technical requirements and procedures that must be complied with in order for a transaction to qualify for nonrecognition treatment under section 1031. Two recent Tax Court cases provide real estate professionals with a friendly reminder of just how easy it is to stumble into one of many section 1031 pitfalls.

Background

Section 1031 provides that no gain or loss is recognized on the exchange of property held for productive use in a trade or business or for investment if it is exchanged solely for property of a "like kind" which is to be held either for productive use in a trade or business or for investment. If a transaction would have been tax-free under section 1031 but for the fact that the taxpayer receives both qualifying replacement property and "boot" (e.g., money or non-like kind property), then the taxpayer recognizes gain from its disposition of the relinquished property to the extent of the boot received.

The Treasury Regulations explain that the words "like kind" refer to "the nature or character of the property and not to its grade or quality." As a result, unimproved land is considered to be like-kind to the Empire State Building. The Regulations also provide that a leasehold interest of real estate with at least 30 years to run is like-kind to a fee interest.

Section 1031 and the applicable Regulations permit both simultaneous and deferred like-kind exchanges. In a deferred exchange, the property sold by the taxpayer (the "relinquished property") is transferred by the taxpayer prior to the taxpayer's acquisition of new property (the "replacement property") in the exchange. Replacement property must be identified within 45 days of the transfer of the relinquished property and must be acquired within 180 days of the transfer (or prior to the due date of the taxpayer's return, including extensions, if earlier). The transaction must be structured so that the taxpayer engaging in the like-kind exchange does not actually or constructively receive the sale proceeds from the transfer of the relinquished property before receiving like-kind replacement property. The Regulations provide that this requirement can be satisfied by having the purchaser of the replacement property deposit the purchase price for that property with a "qualified intermediary" (described below) or in a "qualified escrow account," in either case limiting the taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of that money. However, because of other issues, it generally is not possible to carry out a like-kind exchange through a qualified escrow account except for the unusual case where the purchaser of the relinquished property is also the seller of the replacement property.

Since few exchanges occur directly between only two parties, like-kind exchanges generally require the use of an unrelated third party engaged by the taxpayer (referred to as a "qualified intermediary," or "QI"). Typically, the taxpayer assigns the purchase and sale contract on both the relinquished property and the replacement property to the QI. The QI is the party who carries out the exchange, selling the relinquished property to a third party and holding the sales proceeds in an "exchange account" for up to 180 days. To complete the deferred exchange, the taxpayer (through the QI) acquires the replacement property during the 180-day period with funds from the exchange account, and (pursuant to the direction of the QI) title to the replacement property is transferred directly to the taxpayer.

Recent Cases

Goolsby v. Commissioner

In *Goolsby v. Commissioner*,[1] the Tax Court considered a case involving

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an individual who exchanged a relinquished property for two replacement properties in a transaction which he intended to qualify as a like-kind exchange and which was structured by a company that arranges like-kind exchanges ("IPX"). The issue before the court was whether one of the replacement properties was held for investment or for productive use in a trade or business at the time of the exchange. The taxpayer-husband and his wife had tried to rent the property (a residence) for two months after acquiring it and then, upon failing to do so, moved into the property as their permanent primary residence and stopped trying to find a renter.

The Tax Court agreed with the IRS's contention that the property was not held for investment or for productive use in a trade or business at the time of the exchange, noting that a variety of circumstances revealed the taxpayer's true intentions. The Tax Court found it to be persuasive that the taxpayer had made his purchase of the replacement property contingent upon him and his wife selling what had been their primary residence. Also, they had tried to rent the property for only two months, and the sum total of their efforts toward finding a renter consisted of placing an ad in a neighborhood newspaper. Notably, the Tax Court used the taxpayer's correspondences with IPX (unprivileged communications) against him, finding it significant that he had inquired of IPX regarding whether they could move into this replacement property as their primary residence if they were unable to find a renter.

Crandall v. Commissioner

Crandall v. Commissioner[2] is another Tax Court decision involving a failed like-kind exchange. In this case, the taxpayers were a husband and wife who owned an undeveloped parcel of real estate that they held for investment. Pursuant to a transaction which they intended to qualify as a tax-free like-kind exchange, they sold this property to a third party and placed most of the proceeds in an escrow account. As will be discussed below, the taxpayers did not use a QI for the transaction. Funds from the escrow account were subsequently used to purchase a replacement property.

The Tax Court focused on the fact that the escrow agreement did not limit the taxpayers' right to receive, pledge, borrow, or otherwise obtain the benefits of the funds as required by the Regulations. As a result, the Tax Court concluded that the transfer of these funds to the escrow account by the purchaser of the relinquished property resulted in a constructive receipt of these funds by the taxpayers. Accordingly, the Tax Court held that the transfer of the relinquished property was a taxable sale and did not qualify for nonrecognition treatment under section 1031. The Tax Court explained its holding by stating that "[t]he Court notes that the tax consequences are not what petitioners intended and the result may seem somewhat harsh," but that "Congress enacted strict provisions under section 1031 with which taxpayers must comply."

As noted above, the taxpayers did not use a QI and tried to have the transaction qualify as a like-kind exchange by having the proceeds from the sale of the relinquished property placed in a qualified escrow account. (Commentators have noted that, since there is no indication that the buyer of the relinquished property was also the seller of the replacement property, it appears that a QI should have been used and that the transaction would have failed to qualify as a like-kind exchange regardless of the language in the escrow agreement.) Even in a transaction where the proceeds from a sale of relinquished property are transferred to a QI, though, an exchange would fail to qualify under section 1031 if the exchange agreement between the taxpayer and the QI did not expressly limit the taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property received. However, a more common misstep when using a QI is for a taxpayer to unwittingly accept a deposit under the purchase and sale agreement for the relinquished property instead of having these funds transferred to the QI.

Conclusion

The basic idea of exchanging one property for another is not rocket science. However, the failure to satisfy any number of requirements can transform an attractive nonrecognition transaction into a most undesirable taxable sale. While it is true that *Goolsby* and *Crandall* did not involve extremely sophisticated taxpayers, it is all too common for transactions to fail to qualify where taxpayers do not receive adequate tax advice. Proper guidance can also permit taxpayers to take advantage of certain less known wrinkles to the section 1031 rules which enable more sophisticated like-kind exchanges. For example, it is possible to structure like-kind exchanges (i) in which the replacement property is purchased prior to the sale of the relinquished property (a "reverse" like-kind exchange), (ii) where there are multiple relinquished and/or replacement properties, and (iii) where the replacement property consists of interests in a partnership that becomes wholly owned by the taxpayer as a result of the exchange. Unfortunately, when dealing with like-kind exchanges, it is all too easy to miss out on golden opportunities -- and possibly on nonrecognition treatment altogether.

[1] T.C. Memo 2010-64.

[2] T.C. Summary Opinion 2011-14.