

By James R. Andrews

# Trading Places

**Practitioners need to avoid the many  
pitfalls in structuring Section 1031  
tax-free exchanges**

**SECTION** 1031 of the Internal Revenue Code provides a powerful tool that, if properly used, can postpone the recognition of gain upon the sale of certain property.<sup>1</sup> Enacted in 1924, Section 1031 has survived every change to the tax laws since then. It has become so familiar, and has been relied upon by so many taxpayers, that some of its limitations and pitfalls are often overlooked. If the section is improperly used, or if it is abused, the result can be increased taxes, malpractice claims, or worse.

In most circumstances a taxpayer must recognize gain or loss upon the sale or exchange of property. For example, if a taxpayer decides that he or she made a mistake in purchasing shares of General Motors and should have purchased shares of Ford Motor Company instead, the taxpayer cannot simply exchange \$10,000 of GM stock for \$10,000 of Ford stock without paying a tax (or suffering a tax loss) on the disposition of the GM shares. However, if the taxpayer decides that rather than purchasing one parcel of real property, Blackacre, he or she should have purchased Whiteacre, the taxpayer can exchange Blackacre for Whiteacre and, provided that the rules of Section 1031 are followed, pay no tax on the exchange.

The requirements that make an exchange subject to Section 1031 are deceptively simple: no gain or loss is recognized when property that is held for productive use in a trade or business or for investment is exchanged solely for property of a "like kind," and the replacement property is also held for a productive use in a trade or business or for investment.<sup>2</sup> In addition, the replacement property must 1) be identified on or before 45 days after the date on which the taxpayer transfers the relinquished property, and 2) the taxpayer must receive the replacement property no later than the earlier of 180 days after the date on which the taxpayer transfers the relinquished property or the due date (including extensions) for the taxpayer's

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tax return for the taxable year in which the transfer of the relinquished property occurs.<sup>3</sup>

The reason that the taxpayer who owns GM stock cannot take advantage of Section 1031 is that the statute specifically excludes transactions involving:

- 1) Stock in trade or other property held primarily for sale.
- 2) Stocks, bonds, or notes.
- 3) Other securities or evidences of indebtedness or interest.
- 4) Interests in a partnership.
- 5) Certificates of trust or beneficial interests.
- 6) Choses in action.<sup>4</sup>

Most exchanges of real property are not direct exchanges between two taxpayers. It is highly unusual for a taxpayer to locate someone who not only owns property of the type the taxpayer is seeking but is willing to trade properties with the taxpayer. On the other hand, if a taxpayer sells a property and then uses the sales proceeds to purchase the property he or she desires, Section 1031 does not apply. The taxpayer received cash for the relinquished property, not real estate.

In the real world most exchanges therefore are three-way or four-way transactions: A desires to exchange Blackacre for Whiteacre, B desires to purchase Blackacre and C desires to sell Whiteacre. B could purchase Whiteacre from C and then exchange properties with A, but B usually prefers a simple direct sale. The desires of all parties can be attained if D is introduced into the transaction. D, who participates for a fee, purchases Whiteacre from C, exchanges Whiteacre for A's Blackacre, and then sells Blackacre to B. In this type of transaction D is referred to as an intermediary.

Often A "sells" Blackacre to the intermediary before the intermediary has purchased Whiteacre, either because A has yet to locate a property he or she wants to acquire, or the closing of the acquisition of Whiteacre is scheduled for a date after the closing of the "sale" of Blackacre. This type of transaction is permitted and is called a deferred exchange or a *Starker* exchange.<sup>5</sup> The 45-day and 180-day time limits were adopted when *Starker* exchanges were legislatively approved. Sometimes A locates and is obligated to purchase Whiteacre before the sale of Blackacre is consummated. This "reverse-*Starker* exchange" is apparently also permitted.<sup>6</sup>

Although the rules for the application of Section 1031 appear simple, the *Journal of Accountancy* recently reported that 5 percent of all claims for malpractice against accountants involve errors related to Section 1031.<sup>7</sup> In at least one case, *Dobrich v. Commissioner*, a taxpayer who sought to evade the strict time limitations for the identification of the replacement property faced criminal prose-

cution and pled guilty to two counts for the delivery of false documents to the Internal Revenue Service.<sup>8</sup> Many more taxpayers have experienced the dismay of seeing the IRS successfully challenge their tax returns because Section 1031 did not apply to a particular transaction. Both taxpayers and their counsel should tread very carefully when structuring a Section 1031 exchange.

### The Basic Traps

The failure to abide by the strict time requirements for the designation and acquisition of the replacement property in a deferred exchange is one of the most common errors in the use of Section 1031. These time requirements are mandatory. Most troublesome appears to be the time limits within which the taxpayer must receive the replacement property. This is often referred to as the 180-day period, but it is really the *earlier* of 180 days after the relinquished property is transferred or the due date of the taxpayer's tax return. For example, if the taxpayer transfers the relinquished property on December 31, the time limit will be April 15 of the following year, the due date for the taxpayer's tax return, unless the taxpayer obtains an extension. In one case a taxpayer received the replacement property after April 15, but argued that, since he could have obtained an automatic extension, the court should consider the receipt of the relinquished property to be timely. The Ninth Circuit rejected that claim.<sup>9</sup>

In *Dobrich*, the plaintiff went to great lengths to create the illusion that he had designated his replacement property within the time limits. He talked two brokers into backdating letters and offers, and he wrote a backdated letter to his attorney identifying the replacement property. After losing his battle with the IRS, the taxpayer paid more than \$1 million in back taxes plus a \$774,307 civil fraud penalty. The record does not state what, if anything, happened to his lawyer.<sup>10</sup>

Another common error is the failure to identify the replacement property in the manner required by the IRS. Treasury regulations provide that to identify replacement property properly, the property must be "unambiguously" designated as replacement property in 1) a written document signed by the taxpayer and sent before the end of the identification period to any person involved in the exchange other than the taxpayer or a "disqualified person" or 2) a written agreement for the exchange of properties signed by all parties to the exchange before the end of the identification period.<sup>11</sup>

Real property is unambiguously described if it is referred to by legal description, street address, or by a "distinguishable" name.<sup>12</sup> It

should be noted however, that the replacement property must be substantially the same as the designated property. A hypothetical example cited in the treasury regulations is the designation of two acres of land on which a barn is located. If only the barn and its underlying property were actually transferred, the exchange would fail to qualify for Section 1031 treatment.<sup>13</sup>

The rules on disqualified persons must also be heeded. When *Dobrich* sent his own lawyer the backdated notice identifying his replacement property, he sent it to a disqualified person, so his exchange would have failed even if the notice had been timely sent. Persons who have acted as the taxpayer's attorney, employee, accountant, investment banker or broker, or real estate agent or broker during the two years preceding the transfer of the relinquished property are deemed to be disqualified for notification purposes.<sup>14</sup>

Pursuant to the regulations the maximum number of replacement properties that the taxpayer may identify is three properties without regard to their fair market values or any number of properties as long as their aggregate fair market value at the end of the identification period does not exceed 200 percent of the aggregate fair market value of all the relinquished properties as of the date the relinquished properties were transferred by the taxpayer.<sup>15</sup> With limited exceptions, if the taxpayer identifies more properties than permitted, the IRS will deem that no replacement property has been identified.

The obvious rule that the taxpayer who relinquishes property must be the same taxpayer who receives the replacement property is sometimes overlooked.<sup>16</sup> For example, if the relinquished property is held in the name of a husband, an exchange will be disqualified if the replacement property is taken in the name of both the husband and wife. The IRS has approved some flexibility when the relinquished property is held in the name of an inter vivos grantor's trust for the taxpayer or taxpayers.<sup>17</sup> The IRS was persuaded by the fact that lenders who are willing to finance the acquisition of the replacement property frequently will not lend to a trust and require that the replacement property be taken in the name of the taxpayer as an individual.

Another potentially fatal error is to use the wrong person or entity to act as the intermediary in a deferred exchange. When the *Starker* decision approved the use of a deferred exchange through an intermediary, some taxpayers nominated their attorney (as *Dobrich* did) or accountant to act as the intermediary. The IRS attacked the use of such agents of the taxpayer, asserting that, because of the agency relationship, the taxpayer had

constructive use of the proceeds held by the intermediary. This position was codified in treasury regulations, which list a number of disqualified persons who cannot act as an intermediary.<sup>18</sup>

The regulations offer several entities that can be used as intermediaries, including qualified escrow accounts and trusts and qualified intermediaries. An industry has developed around qualified intermediaries. Many of them are associated with local title companies and are quite good at following the Internal Revenue Code and the treasury regulations. However, it is not enough to use the correct intermediary: if the taxpayer has the ability or unrestricted right to receive money or other property before receiving the like-kind replacement property, the exchange may not qualify for Section 1031 status.<sup>19</sup> A failure to draft properly the escrow instructions, trust agreement, or other agreement could be fatal.

Another common error is to think that, since the transaction is exempt from taxes, the taxpayer can receive cash or other consideration as part of the exchange. While doing so will not disqualify the entire exchange from Section 1031 treatment, the taxpayer cannot defer the taxable gain on that portion of the exchange represented by the fair market value of the personal property or cash.<sup>20</sup> Such cash or property is referred to as boot.

Receipt of boot can arise when the parties attempt to equalize the equities in the properties exchanged. For example, if taxpayer A owns real property with a fair market value of \$350, but subject to a liability of \$150, A has an equity in Property A of \$200. Similarly, if taxpayer B owns real property with a fair market value of \$300, but subject to a liability of \$200, B has an equity in Property B of only \$100. If A and B enter into a Section 1031 transaction to exchange their properties subject to the liabilities, B would have to pay A \$100 in cash in order for the transaction to balance. Under the present rules, the entire \$100 cash will be boot to A, and A will not receive the full benefits of a Section 1031 exchange.<sup>21</sup>

A taxpayer can be in receipt of boot even if the taxpayer does not receive cash or property. Boot also exists when the relinquished property is encumbered by a trust deed note that is less than that which encumbers the replacement property. For example, if a taxpayer, in a transaction qualifying under Section 1031, surrenders property with a fair market value of \$200 and subject to a liability of \$100 in exchange for property with a fair market value of \$150 and subject to a liability of \$50, the taxpayer is relieved of \$50 of liabilities and may have to recognize a gain or boot of that amount.<sup>22</sup> The practical way to avoid the receipt of this type of boot is to

make sure that the lien against the replacement property is at least as large as the lien against the relinquished property.

Although the requirement of Section 1031 that the exchange be of "like kind property" is relatively easy to comply with in an exchange involving real properties, there are some traps. Most real estate is considered of like kind to other real estate. The fact that one of the exchanged parcels is improved while the other is unimproved is not material, because that characteristic only determines the property's grade or quality and not its "kind."<sup>23</sup> Examples of approved like-kind exchanges of real property include:

- An undivided interest in real estate held as a tenant in common for a fee absolute interest.<sup>24</sup>
- City real estate for a ranch or farm.<sup>25</sup>
- A fee interest for a leasehold with 30 years or more to run.<sup>26</sup>
- A fee interest for a "perpetual scenic conservation easement."<sup>27</sup>

But not all exchanges for real estate qualify. Real property located in the United States and real property located outside the United States are not like-kind properties.<sup>28</sup> However, foreign property can be exchanged for other foreign property.<sup>29</sup> In another example, the IRS disallowed an exchange that appears on its face to be an exchange of like-kind real property interests. A father owned Farm F, and his son owned Farm S. The father created

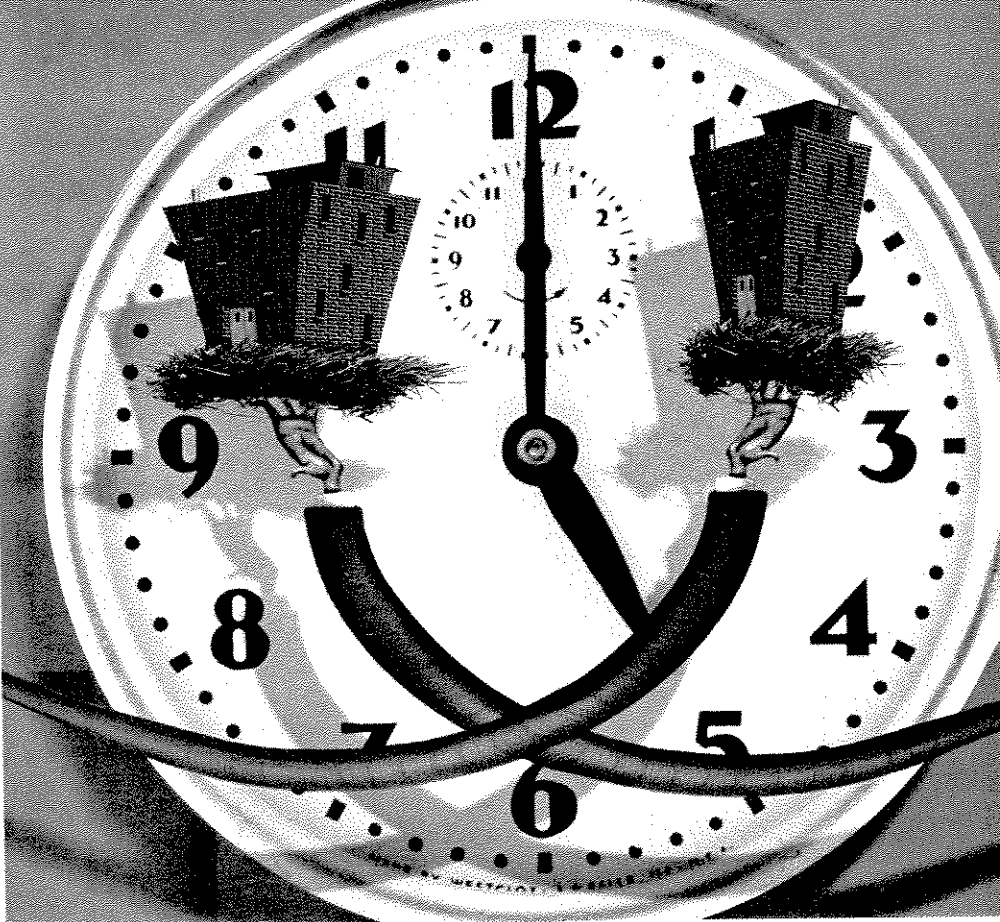
a life estate in Farm F and exchanged the remainder interest in Farm F for a life estate in Farm S. The IRS ruled that the son merely leased Farm S to his father in consideration for the remainder interest in Farm F.<sup>30</sup>

### Advanced Traps

Section 1031 exchanges are sometimes used when a taxpayer wants to acquire a new building for its business in exchange for its old building. The taxpayer may designate a building site as replacement property, and an intermediary might agree to construct the new building. The IRS has approved certain such build-to-suit exchanges,<sup>31</sup> however, there are many potential pitfalls.

For replacement property to be treated as like kind, the replacement property actually received must be substantially the same property as that which was originally identified as the replacement property. In this example, if the taxpayer identified an unimproved site as the replacement property, but eventually acquires a completed building, the IRS could argue that the replacement property is not the identified property. To avoid this trap, the unambiguous identification of the replacement property must include as much detail on the improvements as is practical at the time the identification is made.<sup>32</sup> Insubstantial changes to the building during its construction will not adversely affect the exchange.<sup>33</sup>

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On the other hand, if the taxpayer identifies a site that includes a description of a to-be-completed building and the construction of the new building is not finished by the end of the period within which the taxpayer must acquire the replacement property, the exchange may fail in whole or in part, even though the taxpayer takes title to the property (with a partially completed building) within the mandatory acquisition period. It will fail if the uncompleted building is considered to be personal property under local law. It will also fail owing to the additional construction work performed after the taxpayer takes title to the property, because the relinquished property will be considered to have been transferred, at least partially, in exchange for services.<sup>34</sup>

As with most areas of tax law, dealings between related parties create special problems. For example, Section 1031(f) provides that taxpayers who directly or indirectly exchange property with a related party must hold the exchanged property for at least two years after the exchange in order for the exchange to qualify for Section 1031 treatment. If either party to the exchange disposes of the property received in the exchange before the end of the two-year period, any gain or loss that would have been recognized on the original exchange will be recognized on the date that the disqualifying disposition occurs.<sup>35</sup>

Any transaction involving multiple nontaxable transactions needs to be carefully examined. In *Magneson v. Commissioner*,<sup>36</sup> the Ninth Circuit approved a transaction for Section 1031 treatment, against the claim of the IRS, when a California couple first exchanged real property for an undivided interest in new real property and then, that same day, contributed their undivided interest to a new limited partnership in exchange for a general partnership interest. Both transactions viewed alone qualified as nontaxable transfers, but the IRS had challenged the combination, arguing that the couple did not intend to hold the undivided interest for investment. The court ruled, however, that, because the partnership held the replacement property for investment, that use was attributable to the couple in their capacity as general partners.

Similarly, in *Maloney v. Commissioner*,<sup>37</sup> the U.S. Tax Court held that investment property held by a wholly owned corporation, which was exchanged for other investment property and then distributed to the shareholders in complete liquidation of the corporation, qualified for a Section 1031 transaction.

In spite of the holdings in *Magneson* and *Maloney* and the IRS's apparent acceptance of the *Magneson* decision,<sup>38</sup> the IRS still sometimes takes the position that a transaction may not qualify under Section 1031 if the replacement property is immediately disposed of in a subsequent nontaxable transaction, particularly if the disposition is prearranged. In a letter ruling the IRS refused to sanction a multiple party, partially nontaxable transaction.<sup>39</sup> In that case, partners of a partnership had a dispute: some wanted to sell the appreciated property owned by the partnership and cash out, while others wanted to exchange the property for a replacement parcel as provided in Section 1031. The partnership proposed to sell the property and to transfer to a qualified exchange trust the cash portion that was allocable to the partners who wanted a nontaxable exchange. The trust would then purchase the replacement property and transfer it to the partners who wanted the exchange. The remaining cash proceeds would be distributed to the partners who wanted to cash out. The IRS refused to approve the transaction, stating that the relinquishing party (the partnership) was not the same as the receiving parties (the partners who wanted the exchange) and, consequently, the entire transaction was taxable.

In *Magneson*, the court suggested that the transaction would not have qualified under Section 1031 if the taxpayers had contributed their replacement property to a partnership in exchange for a limited partnership interest or had contributed the replacement property in exchange for the stock of a corporation. In the case of both a transfer to a limited partnership or to a corporation the taxpayer's position would be transformed from one of unlimited liability to one of limited liability. It is obvious from this analysis that taxpayers and their counsel must tread carefully if one aim of a transaction combining two or more tax-exempt transfers is to limit the liability of the taxpayer.

However, one option may still be available to effect this purpose. An area of uncertainty in Section 1031 exchanges lies in the transfer of replacement property to a single-member limited-liability company (SMLLC) when the relinquished property was held by the single member in his, her, or its individual capacity. This would, at first blush, violate the rule that the party transferring the relinquished property must be the same party as the one receiving the replacement property. Nevertheless, Section 1031 may still be available to such a transaction because an SMLLC will be disregarded for federal income tax purposes unless the SMLLC elects to be taxed as a corporation.<sup>40</sup> If the SMLLC is disregarded for federal tax purposes, the party

transferring the relinquished property is the same party as the one receiving the replacement property.<sup>41</sup>

This analysis would also yield the following principles:

- 1) Real property held by an SMLLC or a grantor trust (in each case held in a way that protects the taxpayer from potential liabilities related to the property) can be exchanged for a replacement property, even if the new lender who is going to place a lien upon the replacement property insists that title to the property be held in the individual owner or grantor's name for the brief moment that it takes to record the lender's lien.
- 2) Section 1031 may still apply if a taxpayer is required by the new lender to place the real property into a bankruptcy-remote entity.<sup>42</sup>
- 3) A single parcel of real property can be exchanged for several parcels, each owned by a separate SMLLC.<sup>43</sup>

Although the use of an SMLLC or a grantor's trust provides a potentially beneficial result, it is not without pitfalls. Effective January 1, 2000, new legislation will permit the creation of SMLLCs in California, but the legislation expressly provides that these entities are subject to common law concepts governing alter ego liability.<sup>44</sup> Some practitioners believe that a SMLLC formed in another state is not subject to potential alter ego liability. Although a foreign SMLLC can qualify to do business in California, at least one commentator believes that California will tax a foreign SMLLC as a corporation.<sup>45</sup> Whether foreign or domestic, the SMLLC will have to pay some tax in the state of its formation. These issues of potential liability and extra taxes need to be carefully weighed when advising the use of an SMLLC.

A potential problem may also arise if a grantor's trust is used. If the trustee of the trust is someone other than the grantor (which is often required to obtain the desired tax results), a designation of the property by the trustee may not be a designation of the person who is transferring the relinquished property.

Another pitfall arises when several individuals who own a single property fail to agree on whether to sell it and at what price, for example, when children inherit property or when partners dissolve a partnership. So long as they remain coowners and not partners, the property can be relinquished and exchanged for three replacement properties, so that each of the coowners may own his or her separate property.

If the coowners agree that a Section 1031 exchange will meet their needs, they will quickly recognize that they have a better chance of maximizing the value of the property if they act in unison. If only one owner

attempts an exchange of his or her undivided interest in the property, he or she is unlikely to find a buyer. If all but one attempt an exchange, the recalcitrant owner could hold up the other owners by simply refusing to sign the agreement. A possible solution to this problem is to enter into a tenancy-in-common agreement whereby a majority of the owners can bind all the owners to a sale. However, entering into such an agreement could make Section 1031 unavailable to the owners.

Section 1031 does not apply to an exchange of interests in a partnership.<sup>46</sup> Section 761 of the IRC defines a partnership to include a "group" or "pool" "by means of which any business, financial operation, or venture is carried on." There is a fine line between a coownership arrangement that is not a partnership and one that is a partnership. The IRS has ruled in one case that a coownership arrangement was a partnership because fewer than all the coowners could sell the property, there could be no transfers of individual undivided interests without unanimous consent, and the coowners waived their right to partition the property.<sup>47</sup> This analysis would mean that a simple tenancy-in-common agreement could prevent the use of Section 1031.

### **Practical Traps**

One of the requirements of Section 1031 is that both the relinquished property and the replacement property be held for a productive use in a trade or business or for investment.<sup>48</sup> However, there is no clear rule as to how long a taxpayer must hold a particular property for investment to qualify for a Section 1031 exchange. For example, a taxpayer could not transfer a vacation home or a highly appreciated principal residence in a Section 1031 exchange because property used by the taxpayer for personal use is not being held for investment. Similarly, a developer who has constructed several residential homes cannot exchange unsold homes for income-producing property because Section 1031 does not apply to property held primarily for sale.<sup>49</sup> One potential solution to the problem would be for the taxpayer to rent out the vacation home or residence for a period of time to establish that the property is being held for investment purposes. Unfortunately, there are no clear guidelines indicating how long the taxpayer must rent the property. The taxpayer should therefore be careful when turning property held for personal use or for sale into property held for investment.

Another practical problem can arise if the taxpayer does not carefully examine his or her exit strategy. For example, elderly persons who own apartments or an office building

frequently want to escape the stress of managing property. Or, an elderly owner may die, and the surviving spouse is suddenly faced with management tasks for which he or she is unprepared. Under Section 1031, the burdensome properties can be exchanged for a property leased to a single quality tenant pursuant to a triple net lease, thus permitting the taxpayer to collect rent on the new property without paying taxes on the exchange. The taxpayer can hold the new property until death, the heirs will receive a step-up in tax basis, and no tax will ever be paid on the increase in value of the property.

This strategy, however, presents two possible pitfalls. Often the triple net leased property is a free-standing, single-use property, such as a fast-food restaurant. The taxpayer will enjoy rental income during the term of the lease with few managerial problems, but when the lease ends, the taxpayer owns a facility that has little inherent value. The taxpayer or his or her heirs may find that management problems were only postponed during the term of the lease and will reappear when they seek to sell the property. The important lesson to remember is that triple net leased property acquired through an exchange should both produce income and be readily marketable at the end of the lease term.

A second pitfall arises from so-called phantom income. Unless the taxpayer calculates carefully, he or she may mistakenly believe that there will be sufficient net cash from the new building to live on during the remainder of his or her life. The taxpayer extrapolates from his or her experience with the relinquished property, which regularly produced more cash than taxable income because the depreciation of the old building and the interest paid on the old mortgage exceeded the difference between the rental income and the payments on the mortgage.

Phantom income results in part from the fact that when taxes are avoided at the time of a Section 1031 exchange, the taxpayer's basis in the new property is the sum of the taxpayer's basis in the old property plus the amount of any additional mortgage and cash invested, rather than the full value of the replacement property. Since the taxpayer will frequently have owned the relinquished property for several decades, accumulated depreciation will have significantly reduced its tax basis. As a result of carrying over this low tax basis to the new property, the depreciation available to the taxpayer on the new property will represent a smaller percentage of the rental income than when the taxpayer first purchased the relinquished property years or decades ago.

Another cause of phantom income results from the fact that, on loans that are fully

amortized over their term, interest becomes a smaller percentage of the payments as the loan matures. As a result, the interest payments and deductions available to the owner after a few years represent a smaller percentage of the rental income than when the taxpayer initially exchanged into the replacement property. If the taxpayer lives long enough, the taxpayer will receive less cash than taxable income from the exchanged property. The amount by which the taxable income exceeds the available cash is called phantom income, because the taxpayer is paying taxes on income that he or she never sees. Each year the amount of phantom income and the resulting tax on it increases. Rather than being able to live on the rental income, an elderly taxpayer may actually need to use other assets to pay the taxes.

The taxpayer may follow several approaches in an effort to reduce or eliminate phantom income. These approaches are based on the concept that the deductions available to the taxpayer will be increased (perhaps increased enough to more than offset the phantom income) if the depreciable tax basis of the replacement property and/or the amount of interest being paid is higher than that of the relinquished property. To accomplish this, the taxpayer could "leverage up" by increasing the amount of the loan secured by the replacement property. This will increase the tax basis of the replacement property and the interest the taxpayer will pay. Alternatively, the taxpayer could exchange rental property for raw land and then construct a new income-producing building on the land. In the first strategy, the increase in basis will be allocated between the undepreciable land and the building. In the second strategy, the increase in basis will be allocated solely to the depreciable building.

One problem with both solutions is that they require an increase in debt (or the use of cash that could be used for some other purpose) with a resulting potential increase in risk to the taxpayer. The lesson is that the economics of a Section 1031 exchange must be calculated for the entire period that the taxpayer expects to own the new property, not just for the first year after the exchange.

The tax advantages and apparent simplicity of a Section 1031 exchange often lead taxpayers and their advisers to fall into one or more traps. It is best to consider all potential problems of a Section 1031 exchange in advance and to seek the advice of a practitioner who specializes in such transactions. ■

<sup>1</sup> Many taxpayers think I.R.C. §1031 applies only to real property held for investment purposes. Although not all types of properties can be exchanged under the section, the section does apply to properties other than real estate.