

CHICAGO DEFERRED EXCHANGE COMPANY

1031 BASICS

IRC Section 1031: Like-Kind Exchanges General Statutory Requirements

1. Both the property surrendered and the property received must be held either for productive use in a trade or business, or for investment.
2. The property surrendered and the property received must be of "like-kind."
3. The exchange must be a reciprocal transfer of properties, as distinguished from a sale and repurchase.

1. Business / Investment

Section 1031 does not define the terms "productive use in a trade or business" or "for investment." The Regulations provide that otherwise unproductive property held by a "non-dealer" for future trade or business use or for future appreciation constitutes property held for investment. The relevant qualified use is the use of each property in the Taxpayer's hands. The use of either property in the hands of the other party to the exchange is irrelevant.

Qualifying property must be used in a trade or business in which the Taxpayer is engaged. The test is applied at the time of the exchange without regard to the Taxpayer's motive prior to the exchange.

In Private Letter Ruling 8103117, the Internal Revenue Service ("IRS") ruled that unimproved real estate qualified for a like-kind exchange where the Taxpayer abandoned its original intention to construct a personal residence on it and thereafter held it only for investment. A minimum amount of incidental personal use by a Taxpayer will not taint otherwise qualifying investment property.

The language of Section 1031(a) states that an exchange of like-kind property will qualify provided the property received is "to be held for" productive use or investment. This language reflects the continuity of ownership concept underlying non-taxable exchanges (IRC Reg. §1.1002-1 (c)). How long the property received must be held by the Taxpayer is uncertain. Depending on the facts and circumstances, the IRS may construe subsequent dispositions, taxable or non-taxable, as evidence that the property was not acquired "to be held" so that the initial sale would be taxable.

Over the years, several legislative initiatives have been introduced proposing to modify the language of Section 1031 to impose a one-year holding period on property eligible for tax deferral. While none of the initiatives passed, they serve to provide a glimpse into the position of the IRS on this issue at that time.

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2. Like-Kind: General Rule

All property classified as realty under state law is “like-kind.”

This refers to the nature or character of property, not to its grade or quality. Whether the real estate is improved or unimproved is immaterial. The non-recognition rules of Section 1031 concern the dichotomy between realty and personalty, rather than real estate, which has dissimilar locations, characteristics, or profit-producing uses.

Improved real estate may be exchanged for unimproved real estate, and urban real estate may be exchanged for rural real estate. Mineral and non-mineral real property interests are like-kind to each other, provided the mineral interests are considered real property under applicable state law. A leasehold interest with a duration of at least 30 years, including optional renewal periods, is like-kind to a fee interest in property.

The original version of Section 1031 premised non-recognition on the receipt of property of “like-kind or use.” The “or use” limitation was quickly dropped because it was too difficult to determine if property received at the time of the exchange was to be held for productive use and not for investment. Subsequently, investment property was eligible to be exchanged for like-kind business property without recognition of gain.

3. Property for Property

The essence of an exchange is a reciprocal transfer of properties, as distinguished from a sale for cash and re-investment.

The IRS initially took the position that the reciprocal transfer of properties must be simultaneous. Under this view, a sale today and receipt of like-kind property in the future would not constitute an exchange.

In **Starker v. U.S. 1975-1 USTC 8443 (D. Oregon 1975)**, the Ninth Circuit Court rejected this position and held that a sale of property today in exchange for a promise to deliver like-kind property in the future was a good exchange. The Tax Reform Act of 1984 attempted to provide more certainty in the area of delayed exchanges; however, this is not always the case.

The Tax Court will likely use the “step transaction doctrine” in its analysis of whether the nonrecognition requirements under Section 1031 have been satisfied.

All the legs of the exchange must constitute an integrated, mutually dependent transaction. The Tax Court will look to interdependence, intent, timing, and commitment of the parties to the exchange.

EXCLUDED PROPERTY

Section 1031(a)(2) denies non-recognition treatment to the transfer, or receipt of the following categories of property:

- Stock in trade or other property held primarily for sale
- Stocks, Bonds, or Notes
- Other securities or evidence of indebtedness or interest
- Interests in a Partnership
- Certificate of Trust or Beneficial Interest (see “Illinois Land Trusts” Revenue Ruling 92-105)
- Choses in action

