

Headquarters

LaSalle Bank Building
135 S. LaSalle Street
Chicago, IL 60603
Toll Free (866) 677-1031
Fax (312) 992-4570

New England Branch Office

40 Court Street
Plymouth, MA 02360
Toll Free (877) 811-1031
Fax (508) 732-3201

New York Branch Office

565 5th Avenue
New York, NY 10017
Toll Free (877) 811-1031
Fax (212) 986-4205

Northern California Branch Office

3160 Crow Canyon Road
San Ramon, CA 94583
Toll Free (877) 448-1031
Fax (800) 669-0250

San Diego Branch Office

3900 5th Avenue
San Diego, CA 92103
Toll Free (877) 446-1031
Fax (619) 497-2491

chicagodeferred.com

INTERNAL REVENUE CODE SECTION 1031

The precursor of Section 1031, Section 112, was enacted principally to ease the administrative burden on the Board of Tax Appeals in the event two parties exchanged assets of "like-kind and similar use". How was gain to be computed without an agreed upon sale price? Lurking beneath this practical problem was a fundamental policy issue: if similar assets are exchanged, has there been a "cashing out" that should cause income to be recognized for tax purposes? Seventy-five years later, the very same public policy issues continue to be debated among practitioners and both the executive and legislative branches of government.

STATUTORY REQUIREMENTS

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

BUSINESS/INVESTMENT

Section 1031 does not define either the term "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 property in the hands of the purchaser of relinquished property or the seller of replacement property 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 Service ruled that unimproved real estate qualified for a like-kind exchange where the Taxpayer abandoned his 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 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 reflects the **continuity of ownership** concept underlying nontaxable exchanges. (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 Service may construe subsequent dispositions, taxable or nontaxable, as evidence that the property was not acquired "to be held" so that the initial exchange would be taxable.**

It is interesting to note that there have been two legislative initiatives in the last fifteen years attempting to modify the statute to impose a one-year holding period on property eligible for non-recognition treatment under Section 1031. Both proposals came out of the Treasury Department, and while neither initiative passed, it does give some indication of that administration's position on this issue.

See also: *Private letter ruling 8429039* where the IRS concluded that two years of business use was sufficient to meet the requirement that property be "held for" investment or for use in a trade or business.

Code §1031(a)(1), Reg. §1.1031(a)-1(a), (b).

Exception To The Dealer Prohibition Under IRC Section 1237

Real property subdivided for sale will not be deemed to be held primarily for sale to customers in the ordinary course of the Taxpayer's trade or business merely because the property has been subdivided if:

1. The property has not previously been held by the Taxpayer for sale in the ordinary course of the Taxpayer's trade or business, and,
2. No substantial improvements were made to the property that enhance the value of the lots by more than 10%, and,
3. The Taxpayer has owned the property for at least 5 years.

Code §1237(a)(1)-(3).

See also: *Neal T. Baker Enterprises, Inc. v. Commissioner, T.C. Memo 1998-302* where non-recognition treatment was denied for property deemed to be held "primarily for sale" even though the court found the property was not held as dealer property.

LIKE-KIND PROPERTY

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

Refers to the nature or character of property, not to its grade or quality. The fact that 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 city 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 of at least 30 years duration including, optional renewal periods, is like-kind to a fee.

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 use property without recognition of gain.

Code §1031(a)(1) Reg. §1.1031(a)-1(b),(c),(d).

Exchange of Land for Improvements – Like Kind

Issue: Can Taxpayer exchange improved real property for improvements? Some IRS officials have stated publicly that improved real property is not like kind to improvements. Consider the following.

Example: X owns vacant land that it leases to Y for a term of more than 30 years. The lease allows Y to construct improvements on the property at Y's expense. If Y does construct improvements, Y will be the owner of those improvements and will be entitled to depreciate the improvements. The lease rental is fair value and does not in any way reflect the value of any improvements. Y builds improvements that are considered real property under local law.

The next year (with more than 30 years remaining on the lease), Y contracts with Z to sell the improvements, subject to the ground lease. Z intends to purchase the improvements as replacement property in an exchange in which Z transfers fee title to an office building. The rental payments that Z makes to X are still fair rental value – there is no premium value and there has been no appreciation in the value of the land itself. The payment that Z makes (through its Qualified Intermediary) to Y is attributable to the improvements, not the lease of the land.

Z has effectively exchanged land for improvements – are these properties like-kind?

This issue is separate and distinct from the issue where a Taxpayer desires to exchange real property for improvements made to land currently or recently owned by the Taxpayer. *See discussion at page 132 re: Reverse Exchanges under Section 1031.*

EXCHANGE REQUIREMENT: RECIPROCAL TRANSFER OF PROPERTY

The essence of an exchange is a reciprocal transfer of properties as distinguished from a sale for cash and reinvestment. The Service originally took the position that the reciprocal transfer of property must be simultaneous. Under this view, a transfer 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. The Tax Reform Act of 1984 attempted to provide more certainty in the area of delayed exchanges; however, this is not always the case.

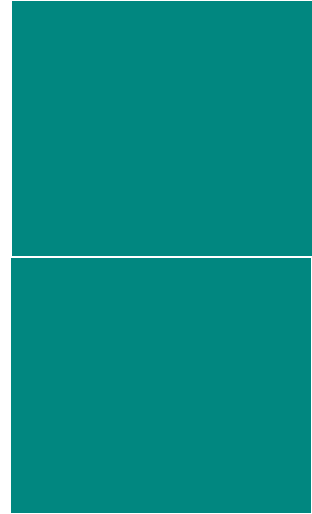
The Tax Court will likely use the step transaction doctrine its analysis of whether the non-recognition requirements under Section 1031 have been satisfied. All the legs of the exchange must constitute an integrated, mutually dependent transaction.

The Tax Court will look to interdependence, intent, timing, and commitment of the parties to the exchange.

Code §1031(a)(1) Reg. §1.1031(a)-1(a).

Three Corner Exchange: Constructive Receipt

The Taxpayer must not have the right to receive the cash proceeds of sale of the relinquished property during the statutory period to complete the exchange. The person from whom property is received need not be the same person to whom the relinquished property was transferred. **Revenue Rulings 57-244 and 90-34; W.D. Haden & Co. v. Commissioner, 165 F.2d 588 (5th Cir. 1948); Reg. §1.1031(k)-1(f).**



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