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Real Estate & Title Insurance Trends

# PROPERTY EXCHANGES DEFER TAXES

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LEARNED HAND earned the distinction as the "tenth Justice of the Supreme Court" by penning opinions that would be quoted by lawyers and laymen alike. In 1934, Circuit Court of Appeals Judge Hand wrote one of his more famous though often misquoted opinions in Helvering, Commissioner of Internal Revenue v. Gregory, 69 F.2d 809 (2d Cir. 1934), aff'd, 293 US 465 (1935):

> We agree with the [United States Board of Tax Appeals] and the taxpayer that a transaction, otherwise within an exception of the tax law, does not lose its immunity, because it is actuated by a desire to avoid, or, if one choose, to evade, taxation. Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes.

Since 1921, one of the best ways to avoid, or more properly, defer taxes when selling property subject to a capital gains tax, is to effectuate a properly structured tax deferred exchange under 1031 of the Internal Revenue Code (IRC) of 1986, as amended. And although property owners and their advisers are becoming increasingly aware of the benefits of an IRC 1031 tax deferred exchange there are still many misconceptions about what like-kind property encompasses and what types of property qualify.

Take for instance the typical sale of a chain restaurant where the proprietor owns the building housing the restaurant, the cooking equipment contained within, and the franchise rights to operate the chain restaurant. Which parts of this transaction are ripe for an IRC 1031 tax deferred exchange? The answer: the building, equipment and franchise rights.

## 1031 Background

First, the concept of a tax deferred exchange owes its existence chiefly to the capital gains tax. For example, if a person purchased Blackacre in 1991 for $100,000, and sold it today for $600,000, that person would have a capital gains on the $500,000, yielding a tax of approximately $125,000. The capital gains tax liability, for purposes of most tax deferred exchanges, is comprised of a federal capital gains tax on appreciation, a federal capital gains tax on depreciation recapture, if applicable, and a state capital gains tax. Most states levy a capital gains tax without differentiating between the amount due to appreciation or depreciation recapture. By structuring this transaction as a tax deferred exchange, this tax need not be recognized.

A tax deferred exchange allows individuals and business entities, such as corporations, partnerships and limited liability companies, to sell their property as part of an exchange, and reinvest the proceeds in a new property, without realizing the gain. The exchanger must structure the transaction as an exchange prior to either the sale of the relinquished property for simultaneous or delayed exchanges. For reverse exchanges, where the replacement property is purchased before the relinquished property is sold, the exchange must be structured prior to the purchase of the replacement property.

In order to have a fully tax deferred exchange the exchanger must: 1) buy replacement property that is of equal or greater value to the relinquished property; 2) reinvest all of the net proceeds from the relinquished property into the replacement property; 3) obtain equal or greater financing for the replacement property as was satisfied on the relinquished property; and 4) purchase only like-kind property. To the extent that some of these rules are not followed, the exchanger may be able to obtain the benefits of a partial tax deferred exchange. For example, an exchanger who sells a relinquished property with a $25,000 basis for $150,000, and purchases a replacement property for $100,000, will have a capital gains tax liability on the $50,000 difference.

Tax deferred exchanges are normally structured as one of four variants: simultaneous, delayed [Treas. Reg. 1.1031(k)-1(a)], reverse [Revenue Procedure 2000-37], and build-to-suit. In the case of a simultaneous or delayed exchange, the exchanger first enters into a contract to sell the relinquished property or properties. A person or entity that is not a disqualified party [Treas. Reg. 1.1031(k)-1(g)(4)(iii)], usually a Qualified Intermediary, thereafter assigns into the rights, but not the obligations of the contract. This assignment creates the legal fiction that the Qualified Intermediary is actually swapping one property for another. In reality, the exchanger sells the relinquished property and purchases the replacement property from whomever he or she wishes in an arms length transaction. There is absolutely no requirement that an exchanger actually "swap" properties with another party.

In addition to the assignment of contract, there must be an exchange agreement entered into prior to the closing of the first property to be exchanged. The exchange agreement sets forth the rights and responsibilities of the exchanger and the entity acting as a qualified intermediary, and classifies the transactions as an exchange, rather than a sale and subsequent purchase. In addition, the exchange agreement must limit the exchanger's rights "to receive, pledge, borrow, or otherwise obtain the benefits of money or other property before the end of the exchange period." Treas. Reg. 1.1031(k)-1(g)(6). That is, the exchanger may only use the exchange funds to purchase new property, and to pay most expenses related to the sale and purchase of the properties.

Once the exchange agreement and assignment of contract are executed, the exchanger sells the property; however instead of collecting the proceeds at the closing, they are sent directly to the Qualified Intermediary. The exchanger thereafter has 45 days in which to identify potential replacement properties and 180 days, or the date upon which the exchanger has to file his or her tax return for the year in which the exchange was initiated, to complete the purchase of the replacement properties. When the replacement property or properties are located, the exchanger enters into a contract to purchase same, and thereafter uses the exchange funds to complete the purchase. This, in very basic form, is the structure of a delayed tax deferred exchange.

## Misconceptions

However, for what can be a very simple transaction, there are many pitfalls, and as previously stated, an equal number of misconceptions. Chief among these misconceptions is the belief that only real property qualifies for tax deferred exchange treatment. The reason for this is clear: most books, articles and continuing education courses on tax deferred exchanges are geared toward real property exchanges and contain only a small portion of information, if any, about personal property exchanges. However, many real property transactions have personal property components that are often overlooked.

Tax deferred exchanges fall into two distinct types: real property and personal property. Both types of property must be held for productive use in a trade or business, or for investment purposes, and be exchanged for property that is to be held for productive use in a trade or business, or for investment purposes. IRC 1031(a)(1). However, real property can only be exchanged for real property, and

personal property can only be exchanged for personal property as they are not like kind to each other. And although tax deferred exchanges are a creature of federal statute, it is state law that determines if a property is real or personal. Treas. Reg. 1.1031(a)-1(b), (c), Aquilino v. United States, 363 U.S. 509 (1960).

Furthermore, like-kind only refers to the nature or character of the property, not to its grade or quality. Treas. Reg. 1.1031(a)-1(b). Nowhere is this concept better illustrated than the typical scenario where an exchange client sells a six-unit apartment building and thereafter seeks to purchase a five- unit apartment building. Time and again the exchanger will explain how he or she has already lined up a contractor to subdivide one of the apartments to make six "like-kind" apartments. Similarly, it is no different where exchangers try to buy the same acreage of vacant land, the same square footage office building, or the same type of two- family house. In each of these examples the exchanger is far too strictly construing the requirement to purchase like-kind property as a much more restrictive requirement by far. This type of restriction is more in keeping with an IRC 1033 tax deferred exchange for property that has been involuntarily converted as a result of a condemnation or casualty.

IRC 1033(a)(1) provides that if property, as a result of its destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof, is compulsorily or involuntarily converted into property similar or related in service or use to the property so converted, no gain shall be recognized. For purposes of an IRC 1031 tax deferred exchange real property will be considered like-kind if it is held for productive use in a trade or business or for investment purposes. Treas. Reg. 1.1031(a)-1. Any real property fitting this definition will be considered like-kind to all other real property fitting this description, regardless of whether the properties are industrial, commercial or residential. Accordingly, an exchange of vacant land for an office building is valid, for example, if said properties were held for productive use in a trade or business or for investment purposes.

However, much more restrictive rules control exchanges of personal property. The Treasury Regulations provide that depreciable tangible personal property is like-kind if it is within the same General Asset Class or within the same Product Class. Treas. Reg 1.1031(a)-2(a). The General Asset Classes consist primarily of assets that are used in large numbers in the United States, such as aircraft, automobiles, buses, light general-purpose trucks, heavy general purpose trucks, rail cars and locomotives, and tractor units, for example. If an asset does not fall within a General Asset Class an exchanger must look to the more restrictive Product Classes set forth in the Standard Industrial Classification Manual issued by the Executive Office of the President, Office of Management and Budget. Treas. Reg 1.1031(a)-2(b)(3). Although the "SIC manual," as it is known, was replaced with the North American Industrial Classification System, also known as the NAICS manual, the Treasury Regulations have never been changed to reflect this update in the law. Exchangers must therefore continue to use the SIC manual to determine if properties are among a common Product Class.

Intangible assets such as franchise rights, patents and copyrights, do not fall into any class, although they can be exchanged for property of like kind. Treas. Reg. 1.1031(a)-2(c)(1). Due to the diverse nature of these types of assets exchangers must look to the nature and character of these rights to see if they are exchangeable. For example, an exchange of a restaurant franchise would undoubtedly not be like kind to an automotive service station franchise, but an exchange of one restaurant franchise for a different restaurant franchise would. [PLR 7824051] It is important to distinguish between the actual value of the franchise rights and the intrinsic value of the goodwill or going concern value.

An important distinction when considering an exchange of a business and all its various assets is the value of the business' goodwill or going concern value. Treas. Reg. 1.1031(a)-2(c)(2) provides that "[t]he goodwill or going concern value of a business is not of a like kind to the goodwill or going concern value of another business." The stated reason for this exclusion is that due to the inherent uniqueness of any single business, the goodwill or going concern value of two

businesses could not possibly have the same nature or quality. Thus, an exchange of "Tony's Pizza of N.Y." for "Joe's Pizza of Fla." can only consist of real property and the equipment. The value of Tony's goodwill, which, excluding the real property, represents the bulk of the business' value, is excluded from like-kind exchange treatment.

Multiple Property

As previously stated, both real and personal property may be exchanged, but not for each other. Therefore, where transactions have elements of both real and personal property, care must be taken in the structure of the exchange to provide for the greatest tax benefit.

Let us return to the example we started where a proprietor is selling a chain restaurant. First, we have a building, which is clearly a straightforward real property exchange. Second, we have the cooking equipment, which is considered to be tangible personal property, and thus can be exchanged. Lastly, we have the franchise rights, which can be exchanged for like-kind franchise rights. Structuring this transaction as three separate exchanges works well if each interest is of similar value, but what if the values vary?

Initially, the Internal Revenue Service issued Rev. Rul. 57-365 wherein it stated that an exchange of identical business assets, including real and personal property, of two telephone companies would be considered "property of like kind" within the meaning of 1031 of the Internal Revenue Code. In 1989, Rev. Rul. 89-121 sought to clarify the "identical business asset" rule set forth in Rev. Rul. 57-365 by stating that the mere fact that multiple assets comprise a business or an integrated economic investment does not mean that they may be treated as the disposition of a single property. The IRS stated that a review of the underlying assets pursuant to Rev. Rul. 55-79 was required to determine whether they were to be considered like kind.

The current system, which became effective for all transactions occurring on or after April 11, 1991, requires all exchangers contemplating a multi-asset exchange to group the properties, both real and personal, into like kind or like class groups. Treas. Reg. 1.1031(j)-1. The value to structuring an exchange as a multiple property exchange, as opposed to a separate exchange for each type of asset, is that a multiple property exchange provides an exception to the general rule that requires a property-by-property comparison when computing the gain and basis.

Thus, although the assets are segregated into exchange groups consisting of like-kind properties, the value and liabilities of the property are computed in aggregate with a gain being recognized only to the extent of a difference in these aggregate values. Treas. Reg. 1.1031(j)-1(b). This does not, however, change the computation of the resulting gain or basis, which is determined separately for each exchange group. Treas. Reg. 1.1031(j)- 1(c). The end result is an exchange of multiple properties wherein a greater proportion of the gain can be deferred than if the transaction were structured as several separate exchanges.

In conclusion, a careful review of most commercial real property transactions will often reveal a large amount of depreciated personal property being sold in addition to the real property. By taking the time to review the impact of these additional assets, and contemplating a multiple property exchange, an exchanger can defer much more of its gain than was originally thought possible or feasible.

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