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Commercial Real Estate Investment Newsletter

Essential Elements of Tax Deferred Property Exchanges

The following are points that participants in a tax-deferred exchange should bear in mind when starting an exchange transaction:

- Even though an exchange may be tax-free at the federal level, it may be taxable at the state or local level.
- One party to an exchange may qualify for tax-free treatment even though the other party does not.
- There is no limit on the number of exchanges an investor can make.
- Corporations can make tax-free exchanges.
- When sale of a property would produce a loss, exchanging normally does not make sense because the loss will not be recognized for tax purposes.
- It is legal to make an exchange solely to save taxes.

Under Code Section 1031, which provides for tax-deferred exchanges of property, no gain or loss is recognized on an exchange of real estate where

(1) property held for productive

use in a trade or business or (2) property held for investment purposes is exchanged solely for like-kind property **to be held** either for productive use in a trade or business or for investment purposes.

Once all requirements of a tax-deferred exchange of like-kind properties are met, the tax deferral is mandatory. Taxable gain is deferred until such time that a taxable disposition occurs.

The properties that are exchanged can either be investment properties or business properties or both investment or business properties. Thus, real estate held for productive use in a trade or business can be exchanged tax-free for other properties held for productive use in a trade or business or for investment.

Likewise, real estate held for investment can be exchanged tax-free for other real estate held for investment or for other real estate held for productive use in a trade or business. ➡

November 2013

This publication is not a solicitation but is an information service from this office.

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When ideas in tax and other legal areas in this publication seem to fit your situation, it is recommended that you discuss them with your professional advisor before taking action.

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Neither real estate which is stock in trade nor real estate held primarily for sale can be exchanged tax-free. Other properties which cannot be exchanged tax-free include property being used as a personal residence and not held for investment by its owner, certificates of trust or of beneficial interest, and other securities or evidence of indebtedness or interest.

The essential elements and characteristics of a tax -deferred exchange of like-kind properties are as follows:

- The transaction must amount to an exchange of properties; it cannot be a sale or some other transaction.
- The properties must be of like kind.
- The properties must be held for productive use in business or for investment purposes.
- The properties cannot be stock in trade or property held primarily for sale.

If an exchange otherwise qualifies but includes as part of the consideration for the exchange money or property that does not qualify, the transaction qualifies, but the tax-free treatment does not apply to the money or other property that does not qualify.

If an exchange otherwise qualifies but, as part of the consideration, the other party assumes liability or acquires property that is subject to a liability, the transaction qualifies, but the tax-free treatment does not apply to the assumption of the liability or the liability to which the property is subject.

Once an exchange is completed, the property received cannot be held for resale or as a personal residence if tax-free treatment is desired.

Where an exchange qualifies for tax-free treatment, neither parties to the exchange nor the government can treat it otherwise than as a tax-free exchange.

Deferred Like-Kind Exchanges

A federal court decision in 1979 introduced the concept of the deferred exchange and thus expanded the scope of the tax-free exchange provision in the tax law. Congress then amended Section 1031 of the code by adding subsection (a)(3) giving statutory approval to the deferred exchange but imposing certain limitations.

Example: Arthur and Baker agree to exchange like-kind properties. Arthur already owns the property he is to exchange and transfers title to Baker. In exchange, Baker agrees to transfer to Arthur some time in the future a specified property (or type of property). If Baker does not acquire the property, Baker will pay the price in cash. Except for the fact that the exchange of properties is not simultaneous, the exchange meets all of the requirements of Section 1031.

Two time limits must be met under the Section:

1. The property to be received by Arthur must be identified as such no later than 45 days after the date that Arthur transfers his property to Baker. The replacement property must be identified in a written document signed by the taxpayer and sent (by hand, mail, or telecopy) before the end of the identification period. It must be given to the person obligated to transfer the replacement property to the taxpayer.
2. Arthur must receive the property from Baker no later than earlier of (1) 180 days transfers his property to Baker the due date of Arthur's tax return for the year in which he transfers the property to Baker.

The 180 day rule has two potential traps. The rule is expressed days, not months, so the parties must count the number of actual days after the transfer of the first property. Also, the second property must be actually transferred. Merely signing a binding contract is not enough.

The one point that is clear is that the party who is to receive the identified property cannot receive cash (either actual or constructively) and purchase the property himself, since this violates the basic requirement of a tax-free exchange. □

Combining Build-To-Suit With A Tax-Free Exchange

There is a great deal of control that can be exercised over the type of property to be received in a tax-free exchange. In one case, the taxpayer designed a brand-new building for himself to replace property to be given by him in exchange. In addition, the taxpayer provided financing for the new building's construction.

Since this was a different idea, the problem was presented to the IRS as whether the taxpayer could act as both lender and exchanging party or whether his actions amounted to a purchase of the new property (which would force him to recognize gain on the property given up).

The taxpayer owned an office building but needed →

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additional space. An unrelated party, Mr. Smith, offered to buy the building but the taxpayer wanted a tax-free exchange to avoid the tax on the large increase in value on the property.

The taxpayer located land suitable for construction of a new building. Smith agreed to negotiate a ground lease, construct the building according to the taxpayer's requirements, and then enter into an exchange.

Smith and the landowner entered into a lease that provided as follows:

- Either Smith or an assignee of the ground lease could construct the improvements.
- The ground lessee could mortgage its leasehold interest but the landowner agreed it would not mortgage its fee interest.
- After five years, lessor and lessee each had the option to purchase or sell the land for a fixed amount specified in the lease.
- On the date of the tax-free exchange by Smith with the taxpayer, the ground lease would have a remaining term of 30 years or more (which would make the leasehold qualify for a tax-free exchange).

The taxpayer and Smith then entered into an exchange agreement under which Smith agreed to construct the new building according to plans and specifications approved by the taxpayer. The taxpayer could make changes to the plans before and during construction and had the right to approve costs under contracts to which Smith, the architect, the developer, or any affiliate was a party. The taxpayer could also approve the general contractor and other parties.

At the closing of the exchange, the taxpayer would convey the old building to Smith in exchange for his assignment of his ground leasehold, including the new building.

The exchange would not take place until the building was substantially completed. Its exchange value was Smith's construction costs, including fees, construction loan interest, real property taxes, and insurance. Once Smith had spent a specified amount on the project, the taxpayer would provide construction loan financing to Smith on a nonrecourse, interest bearing basis.

At or before the closing, Smith would repay to the taxpayer as much of the construction loan as was required to equalize the exchange value of the new

and old buildings.

Two other relevant provisions in the exchange agreement were the following:

- **Right to cancel.** The taxpayer had the right, before the execution of the exchange agreement and the commencement of construction, to make environmental, zoning, and similar reviews of the land and cancel the entire arrangement if the results were unsatisfactory. In such event, the taxpayer would reimburse Smith for his expenses incurred.
- **Leaseback.** Immediately after the exchange, the taxpayer would lease back from Smith for 10 years (at a fair rental) the portion of the old building that contained the taxpayer's computer data center.

In its Letter Ruling, the IRS noted that courts have given taxpayers great latitude in structuring exchange transactions. For example, taxpayers may oversee improvements in land to be acquired and advance money toward the purchase of the property to be acquired in the exchange.

On the basis of the facts described in the Ruling, the IRS concluded that Smith's risks of ownership with respect to the new building were substantial enough so that a true exchange would result; put another way, Smith was not acting merely as the taxpayer's agent.

The risk of ownership included the following:

- Smith's obligations under the exchange agreement, including the construction of a building to the taxpayer's requirements.
- The taxpayer's rights as a lender with respect to the financing.
- Smith's obligation to spend a specified amount before the taxpayer would be obligated to provide financing.
- Smith's liability before the exchange for any claims made with respect to the construction or related contracts.
- Smith's obligation under the lease.

The ability of the taxpayer to exercise significant control over the design and construction of replacement property while still qualifying for a tax-free exchange broadens the attractiveness of an exchange in permitting a taxpayer to avoid recognition of the appreciation in value of the original property. □

Land For Residential Development

Recessions do end. Home building is beginning again. Land suitable for residential development will be needed. Land investment is much more complex than it was 10 or 20 years ago. Because of expanded regulation and environmental concerns, the development process is much longer and so more expensive. The time from the initial raw land purchase until final sale of completed homes may be as long as 10 years.

Despite this, the purchase of raw land or partially developed land has the prospect for big profits without the burden of active property management.

The term “subdivision” describes the legal and physical steps taken by a developer to convert raw land into developed land. The most common example is the residential subdivision, because new homes usually precede (and create the need for) retail, commercial, and industrial development.

The subdivision process has three stages:

- Land in its raw or natural state.
- Semi developed land, usually divided into tracts of 20 to 100 acres, including roads and utilities.
- Developed or subdivided land, platted into individual sites for homes as well as commercial structures.

While many developers may wish to work with land tracts as large as 500 to 1,000 acres, such large tracts are not often available. The reason is that land comes on the market in an uneven pattern. The sellers may be farmers, real estate speculators, and others. They may be motivated to market their properties at different times for many reasons. This causes leapfrog development that is a major cause of urban sprawl. A land investor or syndi-

cate, holding a large parcel of land and ready to sell when a developer is ready to start work can often get a premium price.

Following is an example of a quick analysis that a developer may make before entering into a conditional purchase contract for land.

Example: What if the developer is considering the purchase of a 45-acre site that can be developed at an average density of four single-family lots per acre? Five acres would be necessary for a frontage road and other purposes, leaving 40 acres for development. A market study indicates that the 160 lots can be sold for \$35,000 each, or total revenue of \$5.6 million.

Other than the land itself, estimated costs—for development, marketing, and administration—come to \$1.647 million. Financing, covering 100% of the development costs at 12 percent interest, will cost \$505,000. The developer, at this early stage, estimates profit at \$885,000. Therefore, the total cost-plus profit should amount to \$3.037 million.

Subtracting total costs and profit from the projected revenue leaves a balance of \$2.563 million that can be paid for the land, or about \$57,000 an acre.

From the developer’s point of view, this type of analysis has many shortcomings, including no consideration of how quickly lots are sold, no estimate of future inflation, and no means of computing internal rates of return. The method, however, does have the virtue of identifying the various elements that go into the development process’ to this extent, it can be helpful to the land investor in determining how to price the land when finally it is ready to sell. □

Commercial Real Estate Representation

There are a number of ways to buy, sell or exchange investment or commercial real estate. Having the knowledge of what you can do in some tax situations can be the difference between an annual profit or loss in a property that you intend to acquire or one that you already have in inventory.

The professional commercial real estate broker is in the position to represent clients in real estate transactions by setting up sales, exchanges, leases, purchase and sales of options, and management of real estate. A professional real estate practitioner must stay aware of current tax laws and court decisions in order to structure transactions, but does not give legal or tax advice (unless he/she is also an attorney or a certified public accountant). In any complex transaction that might result in changes

in any owner’s legal or tax situation, the other members of the “consulting team” should be the owner’s attorney and CPA. We always recommend meeting with these other professionals during the planning and closing of major real estate transactions.

As commercial brokers, we are part of your professional team. It is our job to create the real estate transactions that will be needed to enhance your estate. We should meet with our clients on a regular basis to evaluate their present position in properties, reviewing plans for future acquisitions or exchanges.

Reviewing your plans and goals can give us the information needed to help us in moving you in new directions as soon as possible, using purchases, sales or tax deferred exchanges. □

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