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The Three Newest and Least-Known 1031 Exchanges

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This article addresses the three newest and least-known 1031 exchanges.

I. Non-Safe Harbor Parking Arrangements May Allow More Than 180 Days to Complete an Exchange

A [1031](#) exchange allows an investor to sell investment or business real estate and reinvest the proceeds into “like-kind” property—without immediately paying capital gains taxes.

When 1031 exchanges were first authorized in 1921, it was thought that landowners had to exchange their relinquished property for replacement property simultaneously. In 1979, the Ninth Circuit Court of Appeals in *Starker* ruled that the sale of relinquished property and the purchase of replacement property did not have to happen at the same time. [Starker v. United States](#), 602 F.2d 1341 (9th Cir. 1979). In response, Congress passed a law in 1984 that explicitly permitted such delayed exchanges and limited the time between sale and purchase to 180 days.

However, the law did not explain how to handle special cases where the new property had to be bought before the old one was sold. To make such transactions work, the replacement property would be temporarily “parked” with a third-party “qualified intermediary,” which forms an LLC that is referred to as an Exchange Accommodation Titleholder (EAT).

Exchange Accommodation Titleholder (EAT)

In the year 2000, the IRS provided a safe harbor for conducting reverse exchanges in Revenue Procedure [2000-37](#). The revenue procedure left open the possibility that reverse exchanges taking longer than 180 days may be valid.

In 2016, the Tax Court ruled in favor of the taxpayer in *Bartell*. [Estate of Bartell](#), 147 T.C. 140 (2016). In that case, the EAT held the replacement property for 17 months before the taxpayer closed on the sale of their relinquished property and purchased the replacement property. The agreement with the EAT committed the EAT to hold the property for up to 24 months. The Tax Court held that existing case law did not limit the time a third-party facilitator may hold title to the replacement property before the exchange must occur.

While this ruling has precedential value, it is possible that a Tax Court in a different circuit could choose not to follow the rationale set forth in the case. However, gradually, since 2016, real estate investors and business owners have been structuring deals requiring more than 180 days in conformity with *Bartell*. At this time, such a matter being done outside the safe harbor is somewhat commonplace, and certainly the IRS is aware that it happens. A lot of time has elapsed since *Bartell*, and there is no evidence that the IRS has disallowed this structure since then.

The Takeaway for Non-Safe-Harbor Reverse Exchange

When a taxpayer has identified a highly desirable replacement property and wants to have more than 180 days from the date of closing on the replacement property to sell her relinquished property, a non-safe-harbor reverse exchange is an option to evaluate.

II. Building on Your Own Property

Sometimes a taxpayer wants to sell a property and use the exchange proceeds to construct improvements on a property “they” already own as part of a 1031 exchange. The quotation marks around “they” are intentional because in a 1031 exchange, the subject of “they” has significant implications.

If the relinquished property and the replacement property are owned by the same taxpayer, exchange proceeds generally may not be used to improve the replacement property. However, this restriction does not apply when the replacement property is owned by an affiliate or other related party. In that case, the exchange proceeds may be used for construction, provided the transaction is properly structured and complies with §1031 requirements.

A taxpayer may find that the best opportunity for reinvestment is to add improvements to a property that one of its affiliates or related parties already owns, rather than purchase a property from someone else. In that case, we start with the fact that fee title is like-kind to a leasehold estate as long as the leasehold estate has 30 years or more remaining, including renewal options. [26 C.F.R. § 1.1031\(a\)-1\(b\)](#). This allows for a leasehold improvement structure in accordance with [IRS Private Letter Rulings 200251008](#) and [200329021](#).

Can a taxpayer transfer property to a related entity and then effectuate a leasehold improvement exchange? Such a question was addressed by the IRS for the first time in [Private Letter Ruling 202520001](#). In that scenario, the taxpayer transferred land to a related party with the intent to initiate a leasehold improvement exchange after 180 days. Conditioned upon the detailed representations made by the taxpayer, the IRS ruled that the exchange would be allowed. Taxpayers and their advisors should review this ruling when both properties are owned by the same taxpayer.

The Takeaway for Building on Your Own Property

In a 1031 exchange, the issue is not whether improvements can be made; rather, the question is who owns the land on which the improvements are to be constructed. If the taxpayer owns both the relinquished and replacement properties, exchange proceeds generally cannot be used to make improvements to the replacement property. But when the replacement property is owned by an affiliate or a related party, perhaps even properties previously owned by the same taxpayer, improvement construction may be permissible.

III. Turning Land and Buildings into Mailbox Money

From an economic standpoint, agricultural or undeveloped land produces a small amount of cash flow, if any, as a percentage of the fair market value of the property. Rental property produces more income, but along with this cash comes toilets, trash, taxes, tenants, and trouble.

In a 1031 exchange under the Internal Revenue Code, a taxpayer who has held real property for productive use in a trade or business or for investment can exchange that real property for any other “like-kind” real property. Exchanges have been part of the Internal Revenue Code since 1921 and represent one of the most effective strategies available to landowners to defer capital gains taxes.

A misconception concerns the types of property that qualify as like-kind. Some mistakenly believe they must exchange apartments for apartments. Not true. The definition of like-kind property is very broad; qualifying replacement real property can be virtually any real property that will be held by the taxpayer for investment purposes or used in a trade or business. Office buildings, retail centers, apartment buildings, and other rentals can be exchanged for less management-intensive properties. [26 C.F.R. § 1.1031\(a\)-1\(b\)](#).

One of the most popular ways to use 1031 exchanges is to turn high-maintenance real estate into “mailbox money” (although nothing is completely management-free) by purchasing one or more of these:

1. Triple Net Properties

A triple-net-lease property is real estate leased to a tenant who is responsible for the ongoing expenses of the property, including real estate taxes, building insurance, and maintenance, in

addition to paying the rent and utilities.

2. Delaware Statutory Trusts

An ownership interest in a Delaware Statutory Trust (DST) is an indirect way of owning investment real estate. This can be appealing to taxpayers who are interested in acquiring a managed real estate investment. The trustee of the DST initially purchases the property and holds title to the property. A sponsor structures the investment and arranges for the issuance of beneficial interests in the DST. Although interests in the DST are treated as securities under federal securities laws, they are treated as ownership of real estate and thus like-kind pursuant to [§1031](#). [Rev. Rul. 2004-86, 2004-2 C.B. 191](#).

3. Oil and Gas Royalties

Mineral rights and royalties have been handed down through generations. Families have been receiving royalties from oil and gas for over 100 years. Until recently, they were only resold to institutions, large endowment funds, and ultra-high-net-worth families. Increasingly, ranch sellers can purchase producing royalties with investments as little as \$100,000 (just as with DSTs) and then receive the cash flow generated by those royalties. [Palmer v. Bender](#), 287 U.S. 551 (1933); [Comm'r v. Crichton](#), 122 F.2d 181 (5th Cir. 1941).

The Takeaway for Mailbox Money

Many property owners are extremely surprised and happy to learn about the opportunity to move from low-performing land or high-maintenance buildings to passive, income-producing properties in a tax-deferred manner.