ATLAS
1031 EXCHANGE

1031 Exchanges: Benefits to Timberland and Forest Landowners

Smart timberland and forest landowners maintain a relentless focus on improving performance of their holdings through portfolio adjustments, divestiture of non-strategic assets while acquiring higher-yielding timber tracts and blocking up adjacent land to existing ownership to benefit from management efficiencies. Improvements in logistical advantage holdings help to sustain working profitable forests that has generated investor interest in 1031 exchanges from forest companies, timber investment management organizations, high net worth family interests and conservation minded investment funds.

Tax Deferral Strategy

The tax deferral 1031 exchange tool has long been used by timber management companies to adjust portfolios divesting of non-strategic assets in one region of the country to another. 1031 exchanges allow the federal and state capital gain to be deferred when real property of equal or greater value is purchased. Much like the farmer looking for ways to improve yields, timberland and forest landowners look to do the same.

Benefits of a 1031 Exchange

Additional benefits of 1031 exchanges include diversification, consolidation, cash flow, appreciation and depreciation and finally liquidity. The ability to move between properties without paying the immediate tax consequence enhances the rational to make changes given market timing can be critical.

The tax deferral tool represents a creative financing tool. The recognized gain or tax is an indefinite interest free loan when used towards acquiring replacement property. The accepted rationale for a 1031 exchange is that it represents a continuation of the investment from the old to the new property. The tax obligation does not go away but it is postponed providing an incentive to acquire new real property.

1031 Tax Expenditures

In 2013, the tax expenditure for 1031 exchanges in the United States was an estimated $3.7 billion. Individuals and corporations deferred $1.4 billion and $2.3 billion in taxes respectively. These numbers are predicted to slowly grow as more and more owners utilize their options to defer taxes and save money for new acquisitions.

The accepted rationale for a 1031 exchange is that it represents a continuation of the investment from the old to the new property. The tax obligation does not go away but it is postponed providing an incentive to acquire new land, commercial and single-family rental properties. Furthermore, the Internal Revenue Service (IRS) 1031 code allows the taxpayer, independent of income tax bracket, to easily and inexpensively replace one asset for another without the immediate tax consequences. Eighty-eight of all exchanges result in payment of the deferred tax.

IRS Code Section 1.1031

The IRS Code Section 1.1031 states "no gain will be recognized on property held for productive use in business or investment when exchanged for like kind property held for productive use in business or investment." Keywords are property and held. "Property" refers to real property while "held" means the time when the property is used in productive use of a business or investment. However, there is no time frame stated in the 1031 code. The shorter the time held, the greater the facts need to be to substantiate that the property is held for the proper intent rather than for a flip or for profit.

Example: What is the ROI?

Illustration: a timberland owner sells 6,300 acres for $1,800 per acre or a gross sales price of $11,340,000. Selling expenses are sales commission, state recording and attorney fees for a net selling price of $10,546,200. The tax triggered is $1,957,613 representing $1,595,880 in federal capital gains and $361,733 in state capital gains tax.

Rather than paying the tax, the landowner can use the $1,957,613 towards acquiring any real estate including timberland. The replacement property will conservatively appreciate at 3% per year in addition to the cash flow generated from selective cuts. In ten years, the return on the investment on $10,546,200 is an estimated $3,627,011 or 34.4% while the use of the $1,957,613 taxable dollars will conservatively return of $673,255.

1031 Eligible Property

Real property is exchanged for real property. Replacement of equal or greater value must be acquired or a tax is triggered on the difference. A 1031 exchange has many rules and requirements, one of which is the use of a Qualified Intermediary to accommodate the exchange.

A partial list of eligible real property includes:

- Land
- Commercial property
- Single family rentals

- Oil and gas royalties
- Thirty-year leases
- Mobile home parks
- Timberland
- Apartments
- Water rights

Property ineligible for 1031 consideration includes:

- Primary residence
- Partnership interests
- Inventory
- Stocks, securities, and notes
- Indebtedness

Mixed Use Exchanges

Often in the sale of timberland, there is a primary residence. That portion of the property designated as the primary residence is the area adjacent to the home including the area where grass is cut. The Internal Revenue Code Section 121 provides for the exclusion of gain up to $250,000 ($500,000 for married persons filing jointly) on the sale if during the five-year period ending on the date of sale the property has been owned and used by the taxpayer as their principal residence totaling two years or more. This exclusion is given only once every two years.

If the taxpayer has owned the residence for less than two years, yet satisfied the ownership and use requirements, a prorated exclusion is granted given a change in place of employment, health or unforeseen circumstances.

Periods of unqualified use or when the home is not used as the taxpayer's residence do not apply towards the excluded gain. Surrounding land not used for residential purposes, but for an investment is eligible for 1031 tax deferral treatment. Consequently, the gain on the primary residence makes use of the Section 121 gain exclusion while the vacant land defers gain under Section 1031. It makes sense for the taxpayer to make use of as much of the Section 121 exclusion as possible given the tax benefits of paying no tax on the excluded gain of $250,000 and $500,000 depending on federal filing status. A Deferred Sales Trust can defer the gain on the balance above the $250,000/$500,000 exclusion.

Revenue Procedure 2005-14 has specific arrangements for when the primary residence is a separate unit from the non-residence like a farmhouse or living unit above the farm shop. The taxpayer can allocate the square footage of the dwelling unit and business portion as an acceptable method of determining the amount of gain attributable to the residential and nonresidential portions of the property.

Example: Mixed Use Property Exchanges

The taxpayer purchased forest land five years ago for $270,000 that includes his primary residence, a separate dwelling unit for his business office and timberland. Based on the square footage of the two units the taxpayer allocates 1/2 of the property's original basis of $270,000 to the residence ($135,000) and ¼ to the business office ($67,500) and ¼ to the timberland ($67,500). The taxpayer claimed depreciation deductions of $17,500 resulting in an adjusted basis of $50,000 for the business office. The taxpayer sells the entire property for $450,000 exchanging for a primary residence, a separate building for his business office and a tract of land. The property's sale price is allocated $225,000 to the residence, $112,500 to the office and $112,500 for the timberland. The replacement property is purchased for $450,000 including a primary residence valued at $225,000, a business office for $112,500 and vacant land for $112,500. The taxpayer realizes a gain of $197,500 in the exchange: $90,000 on the primary residence, $62,500 on the business office and $45,000 on the timberland.

Under Section 121, the taxpayer excludes the $90,000 gain on the sale of his primary residence, paying no tax because he meets the ownership and use requirements. The gain for the business office and timberland is not excluded under Section 121, but because the fair market value of the replacement business property and vacant land is equal to the fair market value of the relinquished business and timberland, the taxpayer receives no cash and defers the remaining gain of $107,500 under Section 1031.

Given a taxpayer income bracket is 25% results in a deferral of an estimated recognized federal and state capital gains tax of $19,460: $7,245 for the timberland and $12,215 for the business office. A 3% appreciation for each of five years results in a future value of the tax deferral of $22,560 or a 15.9% return on investment.

Water Rights

State law determines whether water rights are considered real property. For the purposes of section 1031, perpetual water rights are eligible for gain deferral as real property. Rights that are limited or restricted in duration or quantity are not like kind to a fee interest in real property.

In *Donald Wiechen*, et al. v. U.S., 228 F. Supp. 2nd 1080 (D Ariz 2002), the Court ruled water rights limited in priority, quantity and duration for a 50-year term were not like kind to a fee interest in real property even though the water rights were real property under state law. The Court denied the 1031 exchange on the basis the water rights were restricted as opposed to unlimited use of real property.

In Private Letter Ruling 200404044, the Court ruled in favor of a decision where water rights were limited to a maximum diversion rate and quantity per calendar year but not duration to be like kind to a farm.

Ditch Rights

Congress approved the Food, Conservation and Energy Act of 2008 providing that stock held in a mutual ditch, reservoir or irrigation company, is eligible for 1031 exchanges. Shares can be exchanged, if the ditch, reservoir, or irrigation company is an organization described in Section 501(c)(12)(A) and the highest Court in the State where the company is organized, or applicable State statute recognizes the shares as either real property or interest in real property. A mutual ditch company is a non-profit organization created for the single purpose of managing a joint water distribution service on behalf of its members. Ranchers and farmers are the typical shareholders that have an exclusive right to use the ditch company water in proportion to the number of shares owned.

Oil, Gas and Mineral Interests

Perpetual interest in minerals can be sold separate from the fee interest in the land. For instance, a mineral lease provides the lessee with the right to exhaust minerals for a period of time and inclusive of the costs associated with exploration and extraction. Per Private Letter Ruling 200805012, the lessee's interest in the mineral lease is considered a real estate interest for federal tax purposes.

To the lessor, the mineral royalty represents a royalty interest, bearing no cost of production and the right to receive a percentage of minerals extracted for the duration of the mineral interest. When the mineral lessee grants a sublease while retaining a royalty interest, the IRS adjudicated Revenue Ruling 72-117, 1972-1 C.B. 226, providing unimproved real estate is exchangeable for an overriding oil and gas royalty.

Landowners have a variety of real and personal property that when sold can utilize the 1031 tax deferral strategy for higher-yielding returns.

1031 Exchange Strategies

Forward 1031 Exchange

In a forward 1031 exchange, the replacement property is purchased after the sale of the old property. The suggested steps to a forward 1031 exchange include:

- Determine capital gains and recaptured depreciation taxes triggered when old property is sold.
- Work with a Realtor to list your property.
- Engage a Qualified Intermediary (QI) to accommodate your exchange.
- Once in contract, schedule a closing.

- ➔ At the closing 1031 exchange documents are prepared supporting your intent to affect a 1031 exchange.
- ➔ Net equity from the sale represents your exchange proceeds that are wired to an escrow account under your social security number or tax identification number.
- ➔ By the 45th calendar day, potential replacement properties identified to the QI.
- ➔ A purchase contract is negotiated on the replacement property.
- ➔ Closing date is scheduled.
- ➔ At the second leg closing, exchange documents are prepared for signing.
- ➔ Exchange proceeds are wired to escrow or closing company.
- ➔ Exchange is completed by the 180th calendar day of the first closing.
- ➔ A file is provided of signed exchange documents for you and your accountant.

Reverse 1031 Exchange

A reverse 1031 exchange is when the replacement property is purchased before the sale of the old property. It is a bit more complex given, as in the construction exchange, either the new or the old must be parked temporarily with the Exchange Accommodator Titleholder (EAT). The decision of which property to park depends on whether a new loan is required on the replacement property or the state where the property is located assesses a conveyance or transfer fee. The goal is to minimize the purchase process and taxes. Often it makes sense to park the old property to allow the landowner to purchase the new property as normal. The typical steps to a reverse 1031 exchange include:

- ➔ Determine the capital gains and recapture depreciation when the old property is sold.
- ➔ List the old property with a Realtor and work with them to identify the replacement.
- ➔ Engage a qualified intermediary (QI) to accommodate the reverse 1031 exchange and determine which property should be parked with the EAT.
- ➔ Once in contract for the replacement property, a closing is scheduled.
- ➔ Secure financing requirements.

- ➔ When improvements are to be made to the replacement property, the EAT will be the titleholder. If not, the EAT will be conveyed title to the old property prior to the closing on the new property.
- ➔ By the 45th calendar day, the old or relinquished property is identified to the QI.
- ➔ A sales contract is negotiated on the old property and closing scheduled.
- ➔ At the closing the net equity received is wired to the taxpayer.
- ➔ Exchange is completed by the 180th calendar day post-closing on the replacement property.
- ➔ A file is provided of primary signed exchange documents for you and your accountant to assist in the preparation of IRS Form 8824.

1031 Requirements and Rules

The primary 1031 exchange rules include:

- ➔ The replacement property purchase price is equal to or greater than the old or relinquished property net sales price. Otherwise, a tax is triggered on the difference.
- ➔ The taxpayer who sells is the taxpayer who buys.
- ➔ Replacement properties are identified by the 45th calendar day post-closing with an additional 135 calendar days to complete the exchange.
- ➔ If the old property is sold to a related party, the property must be held for two years before selling or the tax deferred by the 1031 exchange is due.
- ➔ You can purchase the replacement property from a related party, only if they are also initiating a 1031 exchange.
- ➔ The qualified intermediary cannot be considered an agent of the taxpayer for two years prior to the exchange or they are considered a disqualified person.
- ➔ Real property located in the United States can only be exchanged for real property located in the United States. International real property can only be exchanged for real property located internationally.
- ➔ Non-resident aliens or foreigners must comply with FIRPTA when selling real estate.

About the Author

Andy Gustafson, Certified Exchange Specialist®, serves as the managing member of Atlas 1031 Exchange, LLC, a worldwide accommodator of Internal Revenue Code Section 1031. To date, he has accommodated over 1,400 real and personal, simple and complex, domestic and international 1031 exchanges. You can reach him at 800.227.1031 and info@atlas1031.com.


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