INFINITY
Exchange Services, LLC

Using a 1031 Exchange to Develop Property?

Generally, development activities will disallow the use of section 1031 to defer capital gain taxes. However, as a result of a few Private Letter Rulings (PLRs) issued a few years ago, it may be possible to sell to a related party who develops the property and be able to defer capital gain by exchanging into like-kind replacement property purchased from an unrelated third party.

In PLR2007090036 the IRS permitted the following set of events. The taxpayer sold its relinquished property, through a Qualified Intermediary, to a related corporation. The corporation planned to convert the apartments to condominiums and sell them within two years. The taxpayer then acquired its replacement property, through a Qualified Intermediary, from an unrelated party.

What makes PLR200709036 interesting is that it provides a way to develop investment property which has been operated or held for future appreciation for many years without increasing the taxes owed by turning capital gain into ordinary income. For example, if the taxpayer in the PLR had converted the apartment building to condos, it would have converted all of the gain to ordinary income; including the gain attributable to the time the property was operated as an apartment building. By selling the building to a related party (who performed the conversion to and sale of the condos) it was able to defer the capital gain created during the years of operation as an apartment building by acquiring like-kind replacement property from an unrelated party in the 1031 exchange.

For another example of its application, let's assume that you own a tract of land which you would like to develop and sell. You bought it for $1 million, have owned it for ten years and it is worth $3 million now. If you develop and sell the property all of the gain will be taxed as ordinary income (individual federal rate up to 35%), including the $2 million of capital gain created while you held the vacant land for appreciation. However, if you sell the land to a related party (who develops and sells) and buy like kind replacement property from an unrelated party you can defer paying tax on the $2 million gain.

The recent developments in related party exchanges can provide creative taxpayers and their advisors with planning opportunities to build wealth which are not inconsistent with the purposes of section 1031. It should be noted PLRs cannot be relied upon in an audit or court proceeding by anyone other than the taxpayer to whom the PLR was issued. However, tax advisors use them as an indication of the position of the IRS (especially if there are a number of PLRs setting forth a consistent position). Be certain to consult with your tax and legal advisors before entering into any plan relating to taxes.

WWW.1031INFINITY.COM
480-788-8456
1530 E. Williamsfield Rd., Suite 201
Gilbert, AZ 85285