

EXCHANGING ACRES

1031 fever is spreading to farm, ranch and mineral properties in Texas.

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It is no secret that the Texas economy continues its pattern of sustained growth, but in some areas of the state the growth rate is reaching historic heights. Due in part to the rapid urbanization of formerly rural communities, and fueled by the explosion of mineral values arising from the Barnett Shale gas play in North Central Texas, one of the largest natural gas fields in the United States, rural property owners are currently faced with an unprecedented demand for Texas farm and ranch land. The rapid appreciation of real estate and mineral properties in many parts of the state has necessitated efforts by owners to seek out valid mechanisms to defer payment of large capital gains taxes that would arise from the sale of those highly sought-after properties. Consequently, savvy Texas real estate and mineral owners continue to

utilize 1031 exchanges in ever-increasing numbers. Structuring a transaction as a 1031 exchange (also known as a Starker exchange, Starker trust, tax-free exchange and/or tax-deferred exchange) yields important tax benefits, but an incorrect implementation of the scheme could lead to very costly results.

§1031 of the Internal Revenue Code represents one of the last legitimate tax shelters available to owners of real estate. §1031 provides a vehicle to allow real estate owners to defer payment of capital gains tax by reinvesting sales proceeds derived from the sale of property (the relinquished property) into the purchase of similar, or like-kind, real estate (the replacement property). The regulations require the use of a qualified intermediary to hold the funds during the pendency of the exchange. The taxpayer must

not have any actual or constructive control or possession of the funds during the exchange process, or else the exchange will be invalidated.

Traditionally, farm and ranch properties have yielded minimal cash flow due to their mostly unimproved nature. Owners have witnessed a steady growth in property values but have not been able to enjoy the benefits of a regular income stream that other appreciating properties can generate. However, by utilizing a 1031 exchange, a farm and ranch owner may sell the non-producing land and use the proceeds to purchase a different type of replacement property, which would not only continue to appreciate in value but would also throw off a larger monthly income stream, such as an apartment building, retail center or office building located in a more opportune location.

§1031 regulations require that both the relinquished property sold and the replacement property subsequently purchased must be of like-kind nature to each other. However, for purposes of exchanging real estate for real estate, the regulations provide that it is immaterial whether the property is improved or unimproved, urban or rural, farmland or office tower, or residential or commercial.

The successful implementation of a 1031 exchange on the typical Texas farm or ranch property depends on clearing one major obstacle: in order to qualify for tax deferral, both the property transferred and the property received by the taxpayer must be held either for productive use in a trade or business, or for investment. A taxpayer will not obtain tax-deferred treatment if the exchange involves the sale or purchase of property used

for personal use (such as residences). Since the typical farm or ranch consists of not only farm/ranch land but also a home site utilized as the owner's residence, a taxpayer must divide a proposed sale transaction into two separate transactions, initiating an exchange only on that portion of the property that has not been or will not be used for personal purposes. A reasonable amount of land should be surveyed out around the home for personal use, and the remainder shall constitute the exchange property. Any gain allocated to the home itself may benefit from the exclusions contained in §121 of the Code, which allow for an exclusion of gain from the sale of a personal residence up to \$250,000 for an individual and \$500,000 for a married couple.

Moreover, if documented properly, a taxpayer desiring to use exchange proceeds to buy a farm or ranch can also use a portion of funds toward the construction of roads, fences, barns, tanks and other permanent improvements related to the farming/ranching operation on the acquired property. A construction exchange necessitates a much more sophisticated approach, and care must be given to set it up in accordance with the safe harbors afforded under the 1031 regulations.

The Barnett Shale phenomenon has recently led to unprecedented demand for gas rights in North Texas, and investors are seeking protection from capital gains tax on these rapidly appreciating interests through the use of 1031 exchanges. In Texas, most interests in oil, gas and mineral properties are considered to be real prop-

erty under state law. Therefore, under §1031, the income derived from the sale of an interest in minerals can be reinvested in the purchase of any other type of business or investment-related real estate, including other mineral properties, office buildings, retail centers and apartment complexes. However, in order for a mineral interest to qualify as a real property interest for exchange purposes, the mineral interest must be perpetual in nature. For example, an overriding royalty interest in minerals, which would continue until the mineral deposit is exhausted, is considered perpetual in nature and therefore can be exchanged for any other type of business or investment-related real property interest. However, a production payment, whereby the right to payment will terminate within a specified time, is not perpetual in nature and cannot be exchanged for a different type of real estate.

As a result of the strong economy and boom in Texas real estate values, 1031 tax-deferred exchanges are definitely in vogue. They remain as one of the last tax shelters available to real estate owners and investors, who currently are availing themselves of 1031 exchanges in record numbers. The use of a trusted qualified intermediary who understands the complexities and nuances of §1031 is critical to the completion of a successful exchange transaction.

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