Exchanges of Real Estate Contract Rights

Exchanges of real estate contract rights were prevalent during the real estate bubble years of the last decade, particularly in markets such as Florida and Nevada, where investors speculated in residential real estate. Now that the real estate market is finally reviving in many markets, a holder of a right to acquire property, such as an option or similar agreement, may once again find that such right has appreciated significantly, and it can be sold for a substantial gain. This article examines the authorities that address whether gain can be deferred under Code Sec. 1031 when a right to purchase property is sold or exchanged at a gain. It also looks at the structuring of an exchange of such a purchase right.

The article assumes that the purchase right will receive the same tax treatment whether it is an option right or a right under an earnest money agreement or similar purchase agreement, and all such rights will be hereinafter referred to as options.

Is an Option Excluded as a Chose in Action?

Code Sec. 1031(a)(2) excludes several types of property from nonrecognition treatment, including choses in action, and the IRS previously has argued that contract rights should be excluded from Code Sec. 1031 as choses in action. The Supreme Court defined a chose in action to include “the infinite variety of contracts, covenants, and promises, which confer on one party a right to recover a personal chattel or a sum of money from another, by action.” For Code Sec 1031 purposes, a chose in action is...
defined by state law and is typically a right to recover money or other personal property through a judicial proceeding.

Few assets have been excluded from Code Sec. 1031 as choses in action. The IRS has ruled that futures contracts were choses in action and thus excluded from Code Sec. 1031 exchange treatment. However, the IRS also has ruled that trade names were not choses in action because “trade names do not, simply by holding them, actually confer on the holder a right to recover any property or money by action (lawsuit). Rather, such a right in and to the use of a name represents an interest in intangible personal property.” Furthermore, the IRS has allowed exchanges of major league football and baseball player contracts without even raising the issue of whether they were choses in action. The courts also have construed the definition of chose in action narrowly and have been reluctant to exclude other types of contract rights from the application of Code Sec. 1031. In T.J. Starker, discussed further below, the IRS argued that the buyer’s contractual promise to convey replacement property at a later date in a deferred exchange was a chose in action, but the court rejected this argument.

Given the reluctance by both the courts and the IRS to categorize contract rights as choses in action, it appears unlikely that an option right would be excluded from Code Sec. 1031 treatment as a chose in action.

The Option Must Meet the “Qualified Use Requirement” of Code Sec. 1031

The option right must be “property held for productive use in a trade or business or for investment” to qualify under Code Sec. 1031. This is often referred to as the “qualified use” requirement. Option rights, like other assets, can be capital assets if held for investment or Code Sec. 1231 property if held in a trade or business. Code Sec. 1234 provides that if an option or privilege to buy property is a capital asset or Code Sec. 1231 property in the hands of option holder, or if the option property would be a capital asset or Code Sec. 1231 property if acquired by the taxpayer, then the taxpayer has capital gain or gain under Code Sec. 1231 from the sale or exchange of the option. Under Code Sec. 1234(a)(3)(A), the option is not eligible for capital gain treatment if held by a dealer. If an option qualifies for capital gain under Code Sec. 1234A, it should also meet the qualified use requirement of Code Sec. 1031.

**Personal or Real Property?**

It is unclear if an option right for real property is real or personal property for the purposes of Code Sec. 1031. If it is personal property, presumably it can be exchanged for another option right for real property. But if the option right is instead real property, it could be exchanged for a fee interest in real property because all real property is generally like-kind for Code Sec. 1031 purposes.

Some authority exists for the position that an option right is like-kind to a fee interest. In F.B. Biggs, the taxpayer relinquished real property in the exchange but received only a contract to purchase the replacement property from the other party to the exchange and not title to the replacement property. The court held that the contract to purchase was sufficient, relying on language below in the T.J. Starker case.

In T.J. Starker, the taxpayer transferred his real property to Crown Zellerbach Corp. in exchange for the corporation’s promise to acquire other real property in the future and convey it to the taxpayer. The IRS argued that this arrangement did not qualify for Code Sec. 1031 treatment not only because the transfers were not simultaneous, but also because the contract right received by the taxpayer was personal property and, hence, not like-kind to the real property he had conveyed. The Ninth Circuit disagreed, stating:

This is true, but the short answer to this statement is that title to real property, like a contract right to purchase real property, is nothing more than a bundle of potential causes of action: for trespass, to quiet title, for interference with quiet enjoyment, and so on. The bundle of rights associated with ownership is obviously not excluded from section 1031; a contractual right to assume the rights of ownership should not, we believe, be treated as any different than the ownership rights themselves. Even if the contract right includes the possibility of the taxpayer receiving something other than ownership of like-kind property, we hold that it is still of a like kind with ownership for tax purposes when the taxpayer prefers property to cash before and throughout the executor period, and only like-kind property is ultimately received.
Thus, a taxpayer, particularly in the Ninth Circuit, may consider taking the position that an option is like-kind to real property based on the Starker language that the option is “a contractual right to assume the rights of ownership” and therefore should not “be treated as any different than the ownership rights themselves.”

The IRS, in a 1995 Field Service Advice (“FSA”), appeared to come to the same conclusion as the Ninth Circuit in T.J. Starker. It stated that an exchange of land for an option to acquire more land should not be viewed “as a disqualifying aspect” under Code Sec. 1031. The IRS took the position that the exchange was invalid on other grounds, but that it would be contrary to the IRS’s position to challenge the exchange on the basis that it involved, at its root, an exchange of land for an option to acquire land. The FSA pointed out that the Ninth Circuit has allowed exchanges of real property interests with “considerably different characteristics.” The FSA cited C.E. Koch, noting that the taxpayers’ money was “still tied up in real property of the same class or character as they owned before the exchange.” In C.E. Koch, the IRS challenged the taxpayers’ exchange of unencumbered fee interests for fee interests subject to 99-year condominium leases, and stated the following:

Section 1031(a) requires a comparison of the exchanged properties to ascertain whether the nature and character of the transferred rights in and to the respective properties are substantially alike. In making this comparison, consideration must be given to the respective interests in the physical properties, the nature of the title conveyed, the rights of the parties, the duration of the interests, and any other factor bearing on the nature or character of the properties as distinguished from their grade or quality. Significantly, as the standard for comparison, section 1031(a) refers to property of a like – not an identical – kind. The comparison should be directed to ascertaining whether the taxpayer, in making the exchange, has used his property to acquire a new kind of asset or has merely exchanged it for an asset of like nature and character.

The FSA pointed out that the Action on Decision in C.E. Koch expressly stated that the Tax Court was correct in holding for taxpayers and stated that it is “the IRS’s position that an investment in land is of like kind to any other investment in land.” Thus, the FSA recommended that the IRS not challenge the transaction on the basis that the land purchase option was not of like kind to the land transferred. This FSA is highly favorable, and while it is not binding on the IRS, it does provide a roadmap for a thoughtful analysis of the issue.

A contrary argument can be made that an option agreement is not like-kind to real property. Options are typically considered personal property under state law as a contract right. Further, the Tax Court has held that while an option may be “deemed” property in the hands of the option holder, a sharp distinction exists between the character of the rights held by the optionee and an owner of an interest in property. “Until an option is exercised, it remains a mere right to acquire the property and is not a legal interest therein.” Thus, the court ruled that a taxpayer who exercised an option could not tack the holding period of the option to the holding period of the property. The taxpayer in that case had exercised an option contained in a lease and then sold a portion of the subject property three days after taking title and attempted to claim long-term capital gain treatment on the sale.

Transfer of Option Right vs. Acquisition and Immediate Sale of Property

Because the holding period of an option right does not tack to the option property, a taxpayer who exercises an option right that has been held more than one year will acquire a new holding period for the option property. If the taxpayer sells the property immediately after the acquisition, the taxpayer will not receive long-term capital gain treatment. Thus, in a taxable sale scenario, the taxpayer would likely have been better off selling the option right instead of the property itself.

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Code Sec. 1031 does not have a holding period requirement, but, as discussed above, it does have the qualified use requirement, which provides that the taxpayer must hold the relinquished property and the replacement property for investment or for use in a trade or business and not primarily for sale. It is unclear if the taxpayer’s qualified use in holding the option right would tack or be attributed to the option property if the taxpayer acquired it and then immediately transferred it to the buyer in an exchange.

Suppose a taxpayer held an option right to acquire land, and the taxpayer intended to construct an apartment building on the land for a long-term hold. Near the end of the two-year process of permitting the land, the taxpayer received an offer to purchase the option agreement that was just too good to refuse. If the taxpayer exercised the option and acquired the land and then transferred it to the buyer, the qualified use of the option right might not tack for Code Sec. 1031, and the taxpayer may be deemed to have held the land primarily for sale and not for investment or in a trade or business. The IRS has taken this position when the relinquished property in an exchange was acquired by the taxpayer shortly before the exchange. Further, the taxpayer will pay substantial transfer taxes in many jurisdictions by taking title to the option property and immediately transferring it to a new buyer, and these transfer taxes would not be due if the option right were assigned to the buyer instead.

Given these factors, the taxpayer seems better off exchanging the option right rather than the option property itself. First, the gain from the disposition of the option would receive long-term capital gain treatment if the exchange fails. Second, based on the analysis in the FSA, the taxpayer has a good argument that the option right is exchangeable, and the IRS apparently does not want to litigate the issue. Third, the taxpayer has met the qualified use requirement of Code Sec. 1031 because the taxpayer has been held the option for investment or in a trade or business. Finally, the transfer of an option right is ordinarily not subject to a real estate transfer tax.

### What Is the Exchange Value?

Suppose the taxpayer decides to exchange the option right and then to treat it as like-kind to real property. The taxpayer will receive $1 million for the assignment of the option right to the buyer. The purchase price for the land under the option is $4 million. Thus, the buyer will effectively be paying $5 million to acquire the land. What is the value of the relinquished property in the exchange for the taxpayer? Is it $1 million, the value of just the option? Or is it $5 million, the value of both the option itself and the obligation to pay the $4 million purchase price of the land when the option is exercised and the land acquired? The taxpayer will, of course, want the exchange value to be only $1 million. Otherwise, the taxpayer would need to acquire replacement property of $5 million to fully defer the tax on the gain, but the taxpayer would have only $1 million of proceeds to do so. Because the taxpayer is only transferring the option right and not the fee interest, it makes sense that the value of the relinquished property would be only $1 million. Perhaps, the answer may be different if the option has been exercised, or the option agreement is instead a binding purchase agreement, and the taxpayer is contractually obligated to pay the purchase price. Neither the FSA nor the Starker language addresses this issue.

### Structuring the Exchange

The first leg of an exchange of the option right is easy to structure. The taxpayer will enter into an option sale agreement with the buyer. The taxpayer’s rights in the option sale agreement will then be assigned to the qualified intermediary (“QI”) and the buyer notified of the assignment, as provided in the “assignment safe harbor” set forth in the Code Sec. 1031 regulations. When the taxpayer assigns the option right to the buyer, the QI will then receive the $1 million of proceeds from the buyer.

The second leg of the exchange is more challenging to structure. Suppose that the taxpayer wants to acquire a $1 million fee interest in an apartment building. The taxpayer could structure the replace-
ment property acquisition as an acquisition of the purchase agreement for the apartment building, and thus treat the exchange as an exchange of one contract for another. Or the taxpayer could decide to take the position that the option right was real property and acquire the apartment building as the replacement property.

If the taxpayer wants to structure an exchange of contract rights rather than real property, the taxpayer could have the QI enter into the purchase agreement with the seller for the replacement property and assign the purchase agreement to the taxpayer as the acquisition of the replacement property. The taxpayer has thus exchanged a contract for a contract. However, the QI most likely has not paid $1 million to the seller for the purchase contract, so the purchase agreement is not worth $1 million. The QI could deposit the $1 million with the closing agent as a deposit prior to the assignment of the purchase agreement to the taxpayer, but this may run the risk of constructive receipt of the exchange proceeds by the taxpayer because the taxpayer may be able to cancel the purchase agreement once it has been assigned to the taxpayer and obtain all or some of the deposit. Perhaps the QI could agree to fund $1 million of the purchase price at the closing of apartment building as part of the assignment of the purchase agreement to the taxpayer. Or the assignment of the purchase agreement to the taxpayer could occur as part of the closing escrow for the apartment building so the taxpayer never has the ability to obtain the exchange proceeds.

The taxpayer instead may want to treat the option right as like-kind to a fee interest. If so, the taxpayer can enter into the purchase agreement for the replacement property and assign the purchase agreement to the QI, using the assignment safe harbor. The real property, as the replacement property, can then be deeded directly to the taxpayer by the seller.

Acquisition of the Option Property and Subsequent Exchange

The taxpayer may want to acquire the option property and then immediately sell it to the buyer and treat the subsequent disposition as an exchange, despite the short holding period and the clear intent to dispose of the option property immediately after the acquisition. The taxpayer may choose to do this because the lack of authority directly on point regarding an exchange of an option right. Or perhaps the option right is nonassignable, or the taxpayer does not want to alert the seller that the option property has increased in value substantially, thus giving the seller incentive to attempt to wiggle out of the option agreement. In such a situation, the taxpayer has an argument that the intent to exchange, rather than to cash out, meets the qualified use requirement of Code Sec. 1031. While the IRS takes the position that the intent to exchange is not sufficient to meet the qualified use requirement, some courts have ruled otherwise. For example, in one case, the taxpayer was allowed to exercise an option, acquire the relinquished property and exchange it five months later pursuant to a prearranged plan with the buyer. The buyer even lent the taxpayer the funds to purchase the relinquished property. The court upheld the exchange without analyzing whether the taxpayer had held the relinquished property for a qualified use or primarily for sale. And in J.R. Bolker, the Ninth Circuit upheld an exchange in which the taxpayer exchanged property the taxpayer had received as a shareholder in a tax-free liquidation of a corporation. The IRS argued the taxpayer had not met the qualified use requirement of Code Sec. 1031 because the taxpayer had only held the property for three months, but the court rejected the IRS’s argument emphasizing that the intent to exchange is not the intent to liquidate or use the property for personal pursuits.

Conclusion

If the real estate market continues to come back, option holders will once again want to exchange out of the sale of their option rights into other real property. The authority on the exchange of an option for a fee interest is not directly on point, but it still may give the taxpayer and the taxpayer’s advisors some comfort. An exchange of the option right will often be preferable to an acquisition of the property and an immediate resale because the exchange of the option right might preserve the possibility of long-term capital gain on any boot in the exchange, and it will avoid real estate transfer taxes. The taxpayer will need to decide whether to structure the exchange as an exchange for another contract right or the real property itself.
ENDNOTES

1 Code Sec. 1031(a)(2)(F).
5 LTR 8453034 (Sep. 28, 1984).
7 Supra note 3.
8 T.J. Starker, DC-OR, 77-2 ustc ¶9512, 432 FSupp 864, aff’d, rev’d, and rem’d, 79-2 ustc ¶9541, 602 F2d 1341.
9 K.J. Crichton, 42 BTA 900, Dec. 11,273, aff’d, CA-5, 41-2 ustc ¶9638, 122 F2d 181.
10 F.B. Biggs, 69 TC 905, Dec. 35,035, aff’d, CA-5, 81-1 ustc ¶9114, 632 F2d 1171.
11 T.J. Starker, at 1355.
13 California Federal Life Ins. Co., 76 TC 107, Dec. 37,624, aff’d 82-2 ustc ¶9464, 680 F2d 85.
15 Id. at 65.
18 V. Molbreak, 61 TC 382, Dec. 32,267 (1973), aff’d, CA-7, 75-1 ustc ¶9169, 509 F2d 616.
20 Reg. §1.1031(k)-1(g)(iv).
23 J.R. Bolker, 81 TC 782, Dec. 40,558, aff’d, CA-9, 85-1 ustc ¶9400, 760 F2d 1039.
24 For a further discussion of the intent to exchange and the qualified use requirement, see Louis S. Weller, Like-Kind Exchange Corner, Does Code Sec. 1031 Qualified Use Include Intent to Exchange?, PASSTHROUGH ENTITIES, May–June 2011, at 13.