College of Business
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Studies in Management and Accounting for the FOREST PRODUCTS INDUSTRY

TAX FREE EXCHANGES AND TIMBERLAND ACQUISITIONS

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Monograph Number 33
December 1990

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TAX FREE EXCHANGES AND TIMBERLAND ACQUISITIONS

Regardless of the tax consequences, there are many practical reasons why timberland is traded or exchanged. A sawmill owner with timber holdings at a distance from the processing facility can exchange remotely located timber for timber closer to the mill and significantly reduce transportation costs. An exchange might also be executed to consolidate timber holdings into contiguous blocks that allow for better forestry management. This concentration of ownership allows more efficiency in restocking, fertilizing, pre-commercial thinning, and general forestry management and control. This "blocking up" also makes for more productive harvesting. These efficiencies enhance the overall value of the timber contained in the tract. A timber holder contemplating a sale of timberland might enter into an exchange of distant timber for property adjacent to his own to create this additional value prior to sale. In addition, a sawmill owner with non-timber real estate with development potential might be interested in exchanging the non-timber lands for productive timberland and, thereby, utilize the value of the development property in their mill operation. Various federal and state restrictions on the harvest of timber, such as the spotted owl conservation areas, road side and stream side buffer zone requirements, could also create an opportunity for a timber holder to exchange these restricted timber holdings for public timber in order to be compensated for the restrictions imposed by the government agency.

Trading partners in the past have been forest products companies that have closed mills permanently in certain locations. The timberland that is located near the mill is the exchanged property. These companies trade their holdings with other mill owners with remote holdings that are still operating in the area. Timber managers for pension funds, which represents a growing ownership of Pacific Northwest timber, could exchange timber to attempt to "block up" their ownership for more efficient managements and enhanced value. Many other situations present themselves where a timberland exchange is warranted.

Through careful planning, many of the above transactions can be structured as "tax free" exchanges whereby income tax on the transaction is deferred until the property received is sold or otherwise disposed of. This result is contrasted with the immediate tax consequence of the sale of timber land with a subsequent investment in similar property. However, the benefits of a tax free exchange are not available without strict adherence to the tax rules governing this area.

Congress has considered changing Section 1031 over the past several years as a means of raising revenue. Fortunately, this area has remained virtually intact since it was first introduced. The Revenue Reconciliation Act of 1989 altered this area somewhat, but the changes mainly impacted related party transactions. These limited changes indicate that, at least for now, the benefits of Section 1031 are safe.

This article will discuss the technical side of Internal Revenue Code Section 1031, the Income Tax Regulations (both current and proposed), as well as other relevant Revenue Rulings and case law that guide the timberland owner in the planning of transactions that qualify for tax free exchange treatment.

OVERVIEW OF SECTION 1031

Internal Revenue Code Section 1031(a)(1) provides that "no gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of a likekind which is to be held either for productive use in a trade or business or for investment."

EXCHANGE REQUIREMENT

The first element of this section is that an exchange must occur. Income Tax Regulations Section 1.1002-1(d) states that, "ordinarily, to constitute an exchange, a transaction must be a reciprocal transfer of property, as distinguished from a transfer of property for a money consideration only." The early position of the IRS was that the exchange must be simultaneous, i.e., the transfer of likekind property in the future does not constitute an exchange. The position of the IRS was rejected in Starker v. U.S., 602 F2d 1341 (9th Cir. 1979). The 1984 Tax Act specifically approved delayed exchanges but imposed a set time frame during which the exchange must be completed. These rules will be discussed in more detail in a later section.

HOLDING REQUIREMENTS

The second major requirement under Section 1031 is that the property exchanged must be held for productive use in a trade or business or for investment and that property received will be similarly held. This would exclude property held by the taxpayer for personal use. The use of property in the hands of the other party is irrelevant and the focus is solely on the use by the taxpayer. Section 1031(a)(2) prohibits likekind exchange treatment for property that constitutes inventory or other property held primarily for sale as well as other specific kinds of property.

The issue of how long the property must be held was addressed in Bolker v. Commissioner, 760 F2d 1039 (9th Cir. 1985). In Bolker, the 9th Circuit held that a "holding" by the taxpayer could be brief. The court stated that the requirement was met by a taxpayer who received property in the liquidation of a corporation and exchanged that property shortly thereafter for likekind property. The court said the real property received in the liquidation did not have to be held, even briefly, with the intention of keeping it indefinitely in order to qualify it as being held for investment.

The IRS has not acquiesced to the Court's holding in the case and has stated that property cannot be acquired for the sole purpose of making an exchange. Until it is overturned though, the decision in Bolker is good law in the 9th Circuit. In addition, the Committee Reports for the 1989 Tax Act made reference to Bolker in regards to the holding requirement. This would indicate that Congress also believes that Bolker is good law.

LIKEKIND REQUIREMENT

The third major requirement in this area is that the property exchanged must be of a likekind, i.e., real estate for real estate and personal property for personal property. Generally, state law controls in determining what constitutes real or personal property for federal income tax purposes. In the state of Oregon, for example, standing timber is considered to be real estate under Oregon Revised Statue Section 307.010. The concept of "likekind" does not contemplate the quality of the property exchanged, nor does it address the value of the property exchanged. It merely refers to the legal nature of the properties involved in the transaction. One of the changes proposed by the House of Representatives early in the debates regarding the 1989 Tax Act was that property exchanged must be "similar or related in service or use" to property received. In this situation, for example, timberland could not be exchanged for a building, because even though both properties are real property they are not similarly used. Fortunately, this change was not enacted into law and the definition of likekind property remains.

OTHER CONSIDERATIONS

DELAYED EXCHANGES

As mentioned above, property does not have to be exchanged simultaneously. Section 1031(a)(3) requires that, once property is given up in an exchange, the property to be received must be identified on or before the 45th day after the property is given up and received by the earlier of 180-days after the exchange or the due date with extension for the transferor's tax return.

Recently proposed regulations under Section 1031 aim to clarify several issues in the delayed exchange area. These regulations provide some insight as to what constitutes identification of the property to be received by providing such property is "identified" only if it is designated as replacement property in a written document signed by the taxpayer, delivered to a person involved in the exchange (who is not a related party) before the end of the 45-day identification period. The replacement property must be unambiguously described in the document. In addition, there are restrictions on how many properties can be named as replacement property. Proposed Reg. §1.1031(a)-3(c).

Once the taxpayer has transferred his own property, he may be reluctant to rely on an unsecured promise by the transferee to transfer property of a likekind. Transactions are often structured so that the transferee's obligation is in some way secured. In some exchanges, taxpayers may also factor in the time value of money to compensate them for the time from which they relinquished property to when they receive the replacement property. In addition, many parties to an exchange are unwilling to acquire replacement property due to potential unforeseen liabilities associated with the property, e.g., hidden environmental liabilities. A recent ruling by the IRS in this area helps to avoid this problem. Revenue Ruling 90-34, 1990-16 IRB 6 rules that a third party can transfer the exchange property directly to the taxpayer. The party acquiring the taxpayer's property does not have to bother with taking title to the third party's property and then transferring it to the taxpayer.

NON-LIKEKIND PROPERTY

If an exchange would fall within the provisions of Section 1031(a) but for the fact that property received consists of not only likekind property but other property or money, any gain to the recipient is recognized to the extent of the money and fair market value of the "other property" received. Money or other property is commonly called "boot" and includes liabilities assumed by the other party as well as liabilities which the property taken is subject to.

"Other property" includes not only non-likekind property, but also property that is specifically excluded in Section 1031(a). As mentioned above, consideration received in the form of an assumption of liabilities (or a transfer subject to a liability) is to be treated as "other property or money," i.e., (boot), for the purpose of Section 1031(b). Where, in an exchange described in 1031(b), each party to the exchange either assumes the liability of the other party or acquires property subject to a liability, each party's boot is offset by the other's. This is the so-called "netting rule" that often prompts last minute debt restructuring prior to an exchange so that the debt assumed by one party is equal to the debt assumed by the other resulting in no gain on the exchange. This is no longer allowed under the Proposed Regulations.

Under the Proposed Regulations, a taxpayer who incurs a liability "in anticipation" of a likekind exchange will have taxable boot when the other party to the exchange assumes that liability. This is true even if the taxpayer assumes an offsetting liability of the other party. Whether this new "anticipation" standard applies would appear to be a question decided in the facts in each exchange. Depending on the objectives of the parties, the issue could be avoided if the parties transfer their assets free of debt by paying off mortgage balances prior to the exchange and then mortgaging the property received in the transaction.

TAX BASIS

The tax basis for determining the gain on the subsequent sale of property received in a likekind exchange equals the basis of the property given in the exchange plus or minus the net increase or decrease in debt, plus or minus net cash paid or received, plus gain recognized in the transaction. This is referred to as substituted basis.

TAX PLANNING OPPORTUNITY

There still exist some tax planning opportunities for likekind exchanges between related parties even though the use of related parties was limited by the 1989 Tax Reduction Act in Internal Revenue Code Section 1031(f). Section 1031(f) requires that likekind property exchanged between related parties must be held for two years after the exchange in order for the original exchange to be considered tax free. Disposition by either party within two years of the original exchange will cause recognition of the gain deferred.

The effect of this Code provision can be illustrated in the following example. "A" is a corporation that has owned timberland since 1950. "A" is owned 100% by two brothers. "A" owns merchantable timber worth $2,000,000 in which it has a basis of $200,000. "B" is a related corporation that has the same ownership structure as "A." "B" owns pre-merchantable timber in which it has a basis of $1,500,000 with a current value of $2,000,000.

"A" wants to harvest the timber it owns, but due to its low basis would recognize a large gain on the ultimate sale of the logs. "A" would like to exchange its low basis timber for "B's" high basis timber and have "B" harvest the timber and sell the logs. The timber in "B's" case would produce a lower gain due to the substituted basis rule. "B" would have a tax basis in the timber of $1,500,000 versus "A's" basis of $200,000, a difference of $1,300,000. "A" would have deferred gain of $1,800,000 on the exchange. Under the new Code provision, if "A" and "B" exchange the timberland on January 1, 1990 and "B" harvests and sells the timber or sells the timberland on July 1, 1991, "A's" deferred gain on the original exchange would be recognized.

If "B," on the other hand, waits until January 1, 1992 to sell the harvested timber, "A's" gain would continue to be deferred. "B" would recognize gain on the sale of the timber, but the gain would be $1,300,000 <u>less</u> than if "A" had sold the timber because "B" has that much more basis in the property after the exchange.

CONCLUSION

There are many non-tax reasons why timberland owners exchange their properties for other timberland. These practical reasons when combined with the tax benefits of Internal Code §1031 make tax free exchanges of timberland a very attractive alternative to a taxable sale and subsequent reinvestment. In order to qualify for tax free exchange treatment, the Internal Revenue Code, Income Tax Regulations and other legal precedent must be reviewed carefully to ensure that the transaction is property structured.

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