

# PURCHASE CONTRACTS

## "CAN THESE BE EXCHANGED UNDER SECTION 1031?"



### Compliments of

In certain markets across the country, the demand for new construction has been very strong. In those markets, an investor who has executed a purchase agreement for new construction may be able to sell a contract to purchase new construction before taking title to the newly constructed property. A sale of the purchase agreement at a significant tax gain raises the question . . .

### CAN A PURCHASE CONTRACT BE EXCHANGED FOR INVESTMENT PROPERTY UNDER SECTION 1031?

Unfortunately, there is not clear guidance on this subject. Certain tax and legal advisors have argued that there is authority for the proposition that a contract right to purchase investment property is "like-kind" to a fee interest in investment property, and that an investor *should* be able to exchange a contract for real property. Those advisors point to the well known *Starker* case [*Starker v. U.S.* 602 F2d 1342 (9<sup>th</sup> Cir 1979)] in which the court reasoned that ownership of real property represents a "bundle of rights" including the right to use the property, to exclude others, to sell the property, to collect rent and to utilize the mineral rights and natural resources located on the property. That court concluded that a contract to acquire property (which itself is a bundle of rights) should be treated as equivalent to the rights associated with ownership of real property. Other courts have followed this reasoning. See e.g., *Biggs v. Comm.*, 632 F2d 1171, 5<sup>th</sup> Cir 1980; *Brauer v. Comm.*, 74 TC 1134, 1980. Query which of the bundle of rights represented by a purchase contract (the right to acquire property) are included in the rights associated with ownership of property mentioned by the *Starker* court.

While there is language in the foregoing cases that could be used to support the argument that a contract right to acquire property is the same as ownership of real property in certain situations, none of them could be relied upon alone to support the exchange of a purchase contract for real property in a particular Section 1031 exchange. Moreover, the IRS has not given specific advice on the topic or otherwise attempted to resolve the issue of when a contract right is equivalent to a fee interest in real property. Accordingly, an investor is cautioned to discuss such an exchange with their tax and/or legal advisor before engaging in such a transaction.

A related question is whether a purchase contract could be exchanged for another purchase contract. In general, state law characterizes a contract right as intangible personal property. Under Section 1031, personal property held for investment may be exchanged for like-kind investment property, however, the scope of like-kind is much narrower in the case of a personal property exchange. Again, there is limited direct authority for the proposition that one contract would be viewed by the IRS as like-kind to another such contract, but such an exchange would seem to involve rights that are similar in character. Whether the purchase contract was held for investment or not would be another matter that the investor would need to substantiate in the event of an audit. While an investor might want to argue that the contract was acquired with a view to sell before the property was required to be purchased, Section 1031(a) provides that property held primarily for sale is not eligible for an exchange. Again, an investor is cautioned to discuss the exchange of a contract for another contract with a tax and/or legal advisor before committing to such a transaction.



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