Like-Kind Exchanges of Real Estate Under IRC §1031

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I. Introduction

A. Section 1031 is Power Tax-Deferral Technique

Over the past three decades, Congress has enacted various Code provisions and modified existing provisions in an attempt to impede taxpayers’ ability to reduce income tax liability when engaging in real property transactions. The Section 1031 “like-kind” exchange is a powerful tax-deferral technique that has, for the most part, escaped rigorous Congressional scrutiny.1 The statute permits a taxpayer to relinquish property (often real property) held for “productive use in a trade or business” or for “investment” and exchange it for “like kind” replacement property, without recognizing gain or loss. A cash sale of property followed by a cash purchase of like kind property will not constitute a like kind exchange. Halpern v. U.S., 286 F.Supp. 255 (ND Ga. 1968); PLR 7918018. To constitute an “exchange” within the meaning of the statute, the transaction must be a “reciprocal transfer of property, as distinguished from a transfer of property for a money consideration only.” Regs. § 1.1002-1(d). The rationale for nonrecognition in this circumstance stems from Congress’ view that tax should not be imposed on realized gains where the investment continues in nearly identical form.2

1. Terminology

1 The Revenue Act of 1987 originally passed by the House, but not enacted, contained a provision severely restricting like kind exchanges. The Omnibus Budget Reconciliation Act of 1989 (OBRA 1989) originally passed by the House would have eliminated the current “like kind” standard in favor of a “similar or related in service or use” test found in Section 1033, which governs involuntary conversions. However, the final OBRA contained only restrictions concerning related party exchanges. The related party exchange rules, though strict, may be avoided if related parties are willing to wait two years before disposing of property received or relinquished in the exchange.

2 Section 1031 was initially promulgated to avoid taxing gains that were mere “paper profits,” i.e., the taxpayer had realized nothing and to tax them seriously interfered with normal business adjustments. Revenue Act of 1934, Sec. 112.
For purposes of this outline, the terms “exchange” and “like kind exchange” are synonymous, as are the terms “exchange treatment” and “like kind exchange treatment.” “Replacement” property refers to property the taxpayer acquires in the like kind exchange; “relinquished” property refers to property which the taxpayer transfers. The term “taxpayer” refers to the owner of property engaging in a like kind exchange. The term “cash buyer” refers to the person acquiring the relinquished property for cash. The term “cash seller” refers to the person supplying the replacement property. The cash buyer acquiring legal title or the cash seller relinquishing legal title may do so in a direct exchange with the taxpayer, or through an intermediary, who may, depending upon the context, be either an “accommodator” in a multi-party simultaneous exchange under Starker v. U.S., 602 F.2d 1341 (9th Cir. 1979) and Revenue Ruling 77-297; a “qualified intermediary” (QI) in a deferred exchange under Regs. § 1.1031(k)-1; an “exchange accommodation titleholder” (EAT) in a safe harbor “reverse exchange” under Revenue Procedure 2000-37; or an accommodator in a “non safe harbor” reverse exchange. The term “boot” refers to nonqualifying property received in a like kind exchange. Nonqualifying property may consist of (i) cash; (ii) relief from liabilities; (iii) property that could be exchanged under Section 1031, but is not of like kind to the relinquished property; or (iv) property expressly excluded from exchange treatment under Section 1031(a)(2).

2. Write-Off Periods Long by Historical Standards

During the 1980’s, various declining balance methods combined with short write-off periods (i.e., 15 years in 1981 for both nonresidential and residential real estate) created large current depreciation deductions for investments in real property. Depreciation benefits for real estate were significantly curtailed by the Tax Reform Act of 1986. Since 1994, depreciation for all real property has been limited to the straight line method. Nonresidential real estate is now depreciated over 39 years, longer than at any time since 1953. Residential real estate is depreciated over 27½ years, longer than at any time since 1971. (“Depreciation and the Taxation of Real Estate,” Congressional Research Service, Report for Congress, May 12, 1999; Janet G. Gravelle, Senior Specialist in Economic Policy, Government and Finance Division.)

B. Congressional Action to Limit Scope of Section 1031 Exchanges

Section 1031 exchanges have been characterized by Congress as “tax expenditures,” which are defined as spending programs channeled through the tax system. The Joint Committee on Taxation estimates that like kind exchange transactions will reduce federal revenues by $9.1 billion
during fiscal years 2005-2009. Joint Committee on Taxation, Estimated Budget Effects of the Conference Agreement for H.R. 4520, The “American Jobs Creation Act of 2004,” JCX-69-04, Oct. 2004. Given the significant cost to the Treasury of like kind exchanges, it is not surprising that Congress has attempted to limit the number of situations in which the statute could apply, and has imposed more stringent statutory requirements for qualifying “like kind” property.

1. **Section 121 Exclusion Compared**

   Section 121 provides an exclusion of $250,000 ($500,000 for married persons filing joint returns) of capital gain if during the 5-year period ending on the sale date, the taxpayer owned and used the property as a principal residence for periods aggregating 2 years or more.

   a. **Tax Court Holds Residences Cannot be Exchanged**

   Since personal residences are often held for investment, can they be exchanged tax-free? Although some have recently raised this possibility, it appears to be an unwarranted reading of the statute. See, *Bolker v. Com’r* 81 T.C. 782 (1983), *aff’d*, 760 F.2d 1039 (9th Cir. 1985). (Taxpayer cannot convert business property to personal use property and claim exchange treatment.) The Tax Court recently denied like kind exchange treatment for a vacation home used by the taxpayer but never rented. *Barry E. Moore, T.C. Memo, 2007-134.* The decision stated that property held for personal use, such as a principal residence or a “second home” used solely for personal enjoyment cannot qualify under Section 1031 because it is neither held for productive use in a trade or business nor for investment.

2. **Congress Limits Use of Sections 1031 and 121**

   The Jobs Creation Act of 2004 curtailed the use of Sections 121 and 1031 to achieve tax windfalls. Consider taxpayer A who owns both a California home with an adjusted basis is $100,000, and fully depreciated Manhattan rental real estate with a zero basis. The California home is worth of $600,000 and the Manhattan property is valued at $500,000. Both are unencumbered. On January 1, 2006, A swaps the Manhattan rental property for a Florida condo also worth $500,000. A then sells the California residence and excludes $500,000 of gain. After the Florida condo (whose basis is zero) has been rented for six months, A converts it to his principal residence, on June 30, 2006. Two years later, on June 30, 2008, A sells the Florida condo, now
A’s principal residence, still worth $500,000, and again excludes $500,000 of gain. In two and a half years, A has disposed of the zero-basis Manhattan rental property at no gain, and used the Section 121 exclusion twice, to exclude a total of $1 million in capital gain. *Section 121(d)(10) now provides that no residence exclusion may be claimed in connection with the sale of a residence acquired within the preceding five years in a like kind exchange.* A would now have to until January 1st, 2011 – five years from the January 1st, 2006 like kind exchange – before claiming the residence exclusion with respect to the Florida condo.

**C. Property Excluded From Like Kind Exchange Treatment**

Although most like kind exchanges involve real property, tangible personal and even intangible property may be exchanged. However, not all property, even if held for productive use in a trade or business or for investment, may be exchanged under Section 1031. Tax-free exchanges of the following property are expressly excluded by Section 1031(a)(2):

- **A.** Section 1031(a)(2)(A) excludes **STOCK IN TRADE OR OTHER PROPERTY HELD PRIMARILY FOR SALE;**
- **B.** Section 1031(a)(2)(B) excludes **STOCKS, BONDS, OR NOTES;**
- **C.** Section 1031(a)(2)(C) excludes **OTHER SECURITIES OR EVIDENCES OF INDEBTEDNESS OR INTEREST;**
- **D.** Section 1031(a)(2)(D) excludes **INTERESTS IN A PARTNERSHIP;**
- **E.** Section 1031(a)(2)(E) excludes **CERTIFICATES OF TRUST OR BENEFICIAL INTERESTS; AND**
- **F.** Section 1031(a)(2)(F) excludes **CHOSES IN ACTION.**

1. **Stock in Trade or Property Held Primarily For Sale**

“Stock in Trade” refers to property that would be included in inventory. Property held “primarily for sale” cuts a wider swath than property excluded from capital gain treatment under Section 1221(a)(1), which excludes only “property held
for sale *to customers in the ordinary course of trade or business.*” This difference is significant. Some property that would generate capital gain if sold will not qualify for exchange treatment. The sale of a vacant lot purchased for investment would qualify for capital gain treatment if sold, and would qualify for exchange treatment if exchanged for other real estate. However, if the lot had been purchased with the intention of reselling it at a profit, while a sale would still generate capital gain (unless the taxpayer were a dealer), the transaction would not qualify for exchange treatment. Since the exclusion applies to both relinquished and replacement property (*i.e.*, “this subsection shall not apply to any exchange of”) neither the relinquished property nor the replacement property may be held “primarily for sale.” Both must be held for productive use in a trade or business, or for investment.

### a. Dealers in Real Estate

Real estate dealers cannot exchange real property held as inventory, since such property would not be held for productive use in a trade or business or for investment. Whether one is a dealer in real estate involves a “facts and circumstances” inquiry, which considers (i) the reason and purpose for which the property was acquired; (ii) the length of time the property was held; (iii) the sales activity over a period of time; (iv) the amount of gain realized on the sale when compared to gains realized by other dealers or investors; and (v) the extent to which the taxpayer or his agents or employees engaged in sales activities by developing or improving the property, by soliciting customers, or by advertising.

### 2. Stock, Bonds, or Notes

The exchange of stock does not qualify for exchange treatment. However, Section 1036(a) provides for nonrecognition of gains or losses derived from exchanges of common-for-common or preferred-for-preferred stock in the same corporation. In addition, exchanges of stock may be tax-free in the context of corporate reorganizations pursuant to Sections 354 *et seq.*

### 3. Other Securities or Evidences of Indebtedness or Interest

Section 1236(c) defines “securities” as corporate stock or a corporate note, bond, debenture, or right to purchase any of the foregoing.
4. **Choses in Action**

A “chose in action” is a claim or debt upon which a recovery may be made in a lawsuit. It does not constitute present possession, but merely a right upon which suit may be brought. Some contract rights, such as professional baseball player contracts, are deemed to constitute property used in a trade or business and may qualify as like kind exchange property. Revenue Ruling 67-380, 1967-2 C.B. 291. However, a right to receive royalties under an oil payment contract was held to be merely an assignment of income rather than “property,” and would therefore not constitute qualifying exchange property under Section 1031. *Com’r v. P.G. Lake, Inc.*, 356 U.S. 260 (1958).

5. **Certificates of Trust or Beneficial Interests**

Section 1236(c) provides that certificates of trust represent a right to an interest in stock of a corporation. As such, they may not be exchanged under Section 1031.

6. **Partnership Interests**

The Tax Reform Act of 1984 amended Section 1031 to exclude partnership interests from qualifying for exchange treatment. Although some earlier revenue rulings provided otherwise, no exchanges of partnership interests, regardless of whether the exchanges are of general or limited partnership interests, or of interests in the same or different partnerships, can now qualify for exchange treatment. Regs. § 1.1031-1(a)(1).

a. **Election Under Section 761(a)**

The Revenue Reconciliation Act of 1990 amended Section 1031(a)(2) to provide that an interest in a partnership which has in effect a valid election under Section 761(a) shall be treated as an interest in each of the assets of the partnership rather than an interest in the partnership. Under Section 761(a), members of a partnership may elect to exclude the organization from the partnership rules of Subchapter K. Section 761(a)(1) provides that such election may be availed of “for investment purposes only and not for the active conduct of a business.” However, Regs. § 1.761-2(a)(2) requires that the members of such an organization own the property as co-owners.
and not actively conduct business. This requirement would appear to limit the utility of a Section 761(a) election to facilitate the exchange of partnership interests of partnerships owning real estate.

b. **PLR 200909008 – EAT Acquires Partnership Interest**

This ruling concluded that an EAT may acquire a 50% partnership interest as replacement property for the taxpayer’s exchange where the taxpayer owns the other 50%. The partnership’s only asset is real estate. Although IRC § 1031(a)(2)(D) precludes the exchange of a partnership interest, under Rev. Rul. 99-6, the acquisition by a partner of all of the remaining interests of a partnership is treated as the acquisition of a pro rata share of the underlying property.

**D. Holding Period of Replacement Property “Tacked”**

Since the investment following an exchange continues in nearly identical form, Congress provided in Section 1223(1) that the holding period of the property acquired in an exchange is “tacked” onto the holding period of the relinquished property, provided (i) the relinquished property is either a capital asset or Section 1231 property, and (ii) the basis of the property acquired is determined in whole or in part by the basis of the property relinquished.

1. **Holding Period of “Boot” Not Tacked**

Since under Section 1031(d) basis is allocated to nonqualifying property (other than debts or cash) to the extent of that property’s fair market value, condition (ii) is not satisfied. Accordingly, the holding period of nonqualifying property (boot) begins immediately after the exchange.

**E. Tax Deferral Becomes Permanent if Taxpayer Dies**

Section 1031, unlike Section 121, provides a *deferral, but not an exclusion*, of gain (and loss). Realized gain, and the potential for eventual recognized gain, remains in the form of a transferred basis in the replacement property. The deferral becomes permanent if the taxpayer owns the property at death, when (under current law) the property included in a decedent’s estate receives a stepped-up basis under Section 1014(d)(1). Basis problems associated with ownership of real estate through partnership interests can be mitigated distributing the real property to the partner as a tenancy-in-common interest before death, thereby ensuring a stepped-up basis.
F. Potential Capital Gains Tax Savings

Even with reduced capital gains tax rates, substantial tax savings are possible by virtue of a like kind exchange. Net long-term capital gains (i.e., assets held more than 12 months) are now generally taxed at 15 percent. However, Section 1(h)(7)(A) taxes unrecaptured Section 1250 gain at 25 percent. Short term gains are taxed at the taxpayer’s highest ordinary income rate. Section 1(h)(1). New York imposes a maximum 6.85 percent tax on taxable income, without distinction for capital gains. Thus, the combined federal and state rate on long term capital gains (assuming no unrecaptured Section 1250 gain) is 21.85 percent, and 25.5 percent for NYC residents (or NYC property). A Manhattan resident exchanging a zero basis vacant lot worth $1,000,000 (and by definition not subject to unrecaptured Section 1250 gain) could save a total of $271,500 in federal, NYS, and NYC taxes in a like kind exchange. A sale generating short term capital gain attracting a 35 percent federal tax would result in a total tax to New York residents of 41.85 percent and 45.5 percent for NYC residents.

1. TRA 1997 Taxes Unrecaptured Section 1250 Gains at 25 Percent

Section 1(h)(7) taxes unrecaptured Section 1250 gain at 25 percent. Unrecaptured Section 1250 gain generally refers to gain realized on the sale or exchange of real estate that has been depreciated on the straight line basis. For example, assume taxpayer purchased NYC property for $100,000, and has taken $25,000 in straight line depreciation deductions. If the property is later sold for $140,000, realized gain equals $65,000 \( [($140,000 - ($100,000 - $25,000)] \). Total federal tax equals $12,250, which is (i) 15 percent of $40,000, plus (ii) 25 percent of $25,000. The effective federal tax rate would equal 18.85 percent ($12,250/$65,000).

a. Tax Rates Where Property Fully Depreciated

If the NYC property had been fully depreciated using the straight line method, the sale would attract a total tax of 37.15 percent, consisting of (i) a federal tax of 25 percent; (ii) a New York tax of 6.85 percent; and (iii) a NYC tax of 3.65 percent.

b. Effect of Section 1245 Recapture

If a portion of the gain from the sale of real estate is subject to ordinary income recapture of Section 1245, the combined federal and

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3 The lot could have a zero basis if it had been previously acquired in a like kind exchange.
state tax rate would be higher.

2. **Another Example**

Taxpayer sells a building on June 30th, 2006, for $1 million. The building had originally cost $700,000. Of the $300,000 in depreciation deductions taken, $100,000 was in excess of that allowed under the straight line method. Therefore, $200,000 of the depreciation would be unrecovered Section 1250 gain, and $100,000 would be recharacterized as ordinary income under Section 1245. Of the total recognized gain of $600,000 (i.e., $1 million - $400,000), $200,000 would be taxed at 25 percent (unrecovered Section 1250 gain), $100,000 would be taxed at 35 percent4 (“excess” depreciation under Section 1245(a)), and $300,000 would be taxed at 15 percent (LTCG). If taxpayer resided in NYC, the total tax would be $203,200; i.e., $100,000 x .35) + ($200,000 x .25) + ($300,000 x .15) + ($600,000 x .077) + ($600,000 x .045)] The combined federal, state and NYC tax liability would equal 33.87 percent of the realized gain (i.e., $203,200/$600,000).

3. **New York State Transfer Tax**

New York State imposes a transfer tax ("Real Estate Transfer Tax") with respect to conveyances of real property within New York State. (Form TP-584). Transfer taxes are typically paid when one attempts to file the deed with the county clerk. If the deed and accompanying documents are not in proper order, the record clerk will not accept them. Payment of recording taxes are required when the deed is filed. In a situation involving an Exchange Accommodation Titleholder (EAT) in a reverse exchange, the taxpayer claims that the EAT, who acquires “qualified indicia of ownership” (QIA) is merely the agent of the taxpayer, and that no transfer taxes are due, in practical terms the county clerk, and not the courts or the IRS will be deciding whether the EAT is actually acquiring bare legal title, because if the clerk believes that more than bare legal title is being acquired by the EAT, the clerk will refuse to record the deed which states that the EAT owns legal title.

4. **Avoiding Transfer Tax in Swap and Drop Transactions**

**Planning Note:** In some circumstances it will be necessary to “cash out” a partner who wants to receive cash, rather than participate in a deferred exchange.

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4 Assuming the taxpayer was in the 35 percent federal tax bracket.
If an undivided tenancy in common interest in real estate is distributed to the partner, transfer taxes will be incurred. Some transfers of partnership interests which do not involve a “controlling” interest, will not be subject to real estate transfer taxes. However, the transfer of a “controlling” interest in an LLC will be subject to transfer tax in New York, Connecticut, Pennsylvania, and South Carolina. Some like kind exchanges are structured to avoid payment of an extra transfer tax. Two transfer taxes will normally be generated in a like kind exchange: the transfer tax on the sale of the relinquished property, and the transfer tax incurred by the seller of the replacement property. However, if a partner is also being cashed out, a third transfer tax could be incurred. In addition, if the replacement property is acquired by a disregarded single member LLC, a fourth transfer tax could potentially be incurred. Transfer tax planning is thus an important consideration when planning a like kind exchange.

a. **Rate of New York State Transfer Tax**

The rate of transfer tax imposed equals 0.4 percent of the total consideration. The transfer tax is the responsibility of the seller.

b. **New York State “Mansion Tax”**

With respect to conveyances of residential property where the consideration equals $1 million or more, New York imposes an additional tax of 1 percent on the total consideration, the payment of which is the responsibility of the purchaser.

5. **New York City Transfer Tax**

New York City imposes a “Real Property Transfer Tax” (RPTT) on transfers of property in NYC. The tax is based on the total consideration for the conveyance. (Form NYC-RPT). Transfers include the sale or transfer of a 50 percent or greater ownership interest in a corporation, partnership, trust, or other entity that owns or leases real property. A transfer is defined as a change in beneficial ownership. The payment of the RPTT is the responsibility of the seller.

a. **Rate of Tax**

   (1) **Residential Transfers**
The rate imposed on residential transfers equals 1 percent where the consideration is $500,000 or less. If the consideration is more than $500,000, the rate is 1.45 percent. There are no graduated rates. If the consideration exceeds $500,000, the higher rate applies to the entire consideration.

(2) All Other Transfers

The rate of tax imposed on all nonresidential transfers equals 1.45 percent if the consideration is $500,000 or less. If the consideration is more than $500,000, the rate is 2.625 percent. Again, if the consideration exceeds $500,000, the higher rate applies to the entire consideration.

b. Exempt Transfers

Certain transactions are exempt from the RPTT but must be reported. One such exempt transfer, which may be relevant in like kind exchanges, includes transfers from a principal to his agent, or from an agent to his principal. This type of transfer may be involved in a “reverse” exchange, where an Exchange Accommodation Titleholder (EAT) acquires bare legal title to the deed. This could qualify for the “mere change in form or identity” exemption. In a typical forward deferred exchange the Qualified Intermediary (QI) is not required to acquire even bare legal title. The deferred exchange regulations impose a legal fiction in which the QI is deemed to acquire title, even though the relinquished and replacement properties are direct-deeded by the taxpayer, and the QI never acquires record title.

6. Combined NYS & NYC Transfer Tax

The combined NYS and NYC transfer tax on the sale of nonresidential property for $1 million would therefore equal 3.025 percent (i.e., 0.4 percent + 2.625 percent). This would push the tax, as a percentage of realized gain, in the preceding example to 39.28 percent (i.e., [($203,200 + $32,500)/$600,000]. Both
New York State and New York City transfer tax liability would normally arise in connection with a Section 1031 exchange. However, by use of “direct deeding” in an exchange involving a third party, no more transfer tax should arise in connection with a like kind exchange than would otherwise be occasioned by a sale for cash.

7. Other Tax Considerations

New York State taxes are deductible for federal income tax purposes. The examples above do not reflect this tax deduction. However, the amount of money available for reinvestment following a like kind exchange is also not diminished by any income tax paid (except to the extent of boot). Assume first a taxable sale for $1 million, with $700,000 remaining after payment of taxes. Next assume a like kind exchange with respect to the same property. The taxpayer will have 42 percent more to invest in a like kind exchange as compared to a sale (i.e., $300,000/$700,000) assuming replacement property of equal value. If through financing replacement property of greater value is acquired, the increase in cash flow (and potential equity appreciation) possible in an exchange when compared to a sale is even more pronounced.

G. Loss of Cost Basis in Tax-Free Exchange

If fully depreciated real estate is exchanged for like kind real estate in a qualifying tax-free exchange, the replacement property will have a zero basis. Contrast this with a typical purchase, where the buyer takes a full cost basis in the purchased property. This problem can be mitigated somewhat by purchasing property whose value exceeds that of the replacement property. A new cost basis will be available for any cash outlay made to accomplish this, including any new debt incurred to acquire the replacement property. Section 1012; *Crane v. Com’r*, 331 U.S. 1 (1947).

II. Requirements for Like Kind Exchange

A. Transaction May Be Structured For Exchange Treatment

Though technically not elective, compliance with Section 1031 itself, the regulations promulgated thereunder, case law authority, and IRS revenue rulings and revenue procedures should enable the taxpayer to successfully plan for exchange treatment. Accordingly, as a practical matter, exchange treatment is indeed elective.

1. Losses Arising From Sham Sale Disallowed
Since Section 1031 applies to losses as well as gains, the IRS has at times argued that a transaction falls within Section 1031 to deny the taxpayer recognition of realized losses. Thus, in *Horne v. Com’r*, 5 T.C. 250 (1945), the Tax Court disallowed a loss arising from the sale of a membership in a commodity exchange where an identical interest had been sold a few days earlier. The court found that the transaction had been designed solely to obtain a tax loss. The case is interesting since the exchanges which the IRS claimed had occurred were clearly not simultaneous. Yet, more recently the IRS has argued that multiparty exchanges in which gain deferral was sought were not within Section 1031 because those exchanges were not simultaneous. **Note:** Under the deferred exchange rules, a taxpayer today might succeed in recognizing a loss by deliberately failing to identify replacement property within the 45-day identification period described in Section 1031(a)(3)(A).

2. **IRS Attempts to Limit Scope of Section 1031**

IRS attempts to limit the scope like kind exchanges has been limited, in part because Congress used a broad brush when drafting the statute. Over the years, like kind exchanges have acquired a distinct judicial gloss, sometimes reflecting the view of the Circuit Court of Appeals in which the taxpayer resides or litigates. Taxpayers have often emerged victorious in disputes involving the applicability and scope of the statute. For this reason, taxpayers who might otherwise be inclined to obtain an advance ruling may plan an exchange without obtaining such a ruling. Various safe harbors articulated in regulations, revenue rulings and revenue procedures, discussed later, can also facilitate planning for exchanges.

**B. Federal Reporting Requirements**

Proper reporting like-kind exchanges can reduce the chances of audit. Form 8824 ("Like-Kind Exchanges") requires the following information: (i) a description of the relinquished and replacement properties; (ii) identification of related parties to the exchange; and (iii) calculation of realized gain, recognized gain, and the basis of replacement property received. Recently, the IRS has upped the ante and requested detailed information to ensure compliance with the 45-day identification and 180-day exchange periods, which are jurisdictional (i.e., cannot be extended). Sales or exchanges of business property must also be reported on either Schedule D or Form 4797 ("Sales of Business Property"). Form 8824 requires the taxpayer to state whether the replacement property was acquired directly or indirectly from a related party. The instructions state that indirect related party exchanges include (i) an exchange made with a related party through an intermediary (such as a QI
or EAT) or (ii) an exchange made by a disregarded entity (i.e., a single-member LLC) if the taxpayer owns the entity. Form 8824 must be filed for two years following the taxable year of the related party exchange.

C. Substantial Authority

The issue of whether or not an exchange qualifies under Section 1031 is often not clear. If “substantial authority” exists for a position taken on a return, neither the return nor the preparer will be subject to accuracy-related penalties for under reporting under IRC §6662, even if the IRS successfully challenges the position taken. By contrast, if a position is not supported by “substantial authority,” penalties may be imposed unless the position has been adequately disclosed and there is a “reasonable basis” for the position. Substantial authority exists if the weight of authorities supporting the treatment is substantial in relation to the weight of authorities supporting contrary treatment. If substantial authority exists for a position taken on a return, neither the return nor the preparer will be subject to accuracy-related penalties for under reporting under Section 6662, even if the Service successfully challenges the position taken. By contrast, if a position is not supported by “substantial authority,” penalties may be imposed unless the position has been adequately disclosed and there is a “reasonable basis” for the position. Substantial authority exists if the weight of authorities supporting the treatment is substantial in relation to the weight of authorities supporting contrary treatment.

D. IRC Section 6694 Preparer Penalties Change Reporting Landscape

Under revised IRC §6694, a return preparer (or a person who furnishes advice in connection with the preparation of the return) is subject to substantial penalties if the preparer (or advisor) does not have a reasonable basis for concluding that the position taken was more likely than not. If the position taken is not more likely than not, penalties can be avoided by adequate disclosure, provided there is a reasonable basis for the position taken. Under prior law, a reasonable basis for a position taken means that the position has a one-in-three chance of success. P.L. 110-28, §8246(a)(2), 110th Cong., 1st Sess. (5/25/07). This penalty rule applies to all tax returns, including gift and estate tax returns. The penalty imposed is $1,000 or, if greater, one-half of the fee derived (or to be derived) by the tax return preparer with respect to the return. An attorney who gives a legal opinion is deemed to be a non-signing preparer. The fees upon which the penalty is based for a non-signing preparer could reference the larger transaction of which the tax return is only a small part.

1. Notice 2008-13 Provided Interim Relief to Return Preparers

Notice 2008-13 contains new guidance concerning the imposition of return preparer penalties. It provides that until the revised reg
(expected to be issued before the end of 2008) are issued, a preparer can generally continue to rely on taxpayer and third party representations in preparing a return, unless he has reason to know they are wrong. In addition, preparers of many information returns will not be subject to the new penalty provisions unless they willfully Understate tax or act in reckless or intentional disregard of the law. Revised IRC § 6694 joins Circular 230, now two years old (which Roy M. Adams observed effectively “deputizes” attorneys, accountants, financial planners, trust professionals and insurance professionals) in “extend[ing] the government’s reach and help[ing to] fulfill a perceived need to patch up the crumbling voluntary reporting tax system.” The Changing Face of Compliance, + Trusts & Estates, Vol. 147 No. 1, January 2008. The perilous regulatory environment in which attorneys and accountants now find themselves counsels caution when advising clients concerning tax positions. Although a taxpayer’s right to manage his affairs so as to minimize tax liabilities is well settled, Congress has signified its intention to hold tax advisors to a higher standard when rendering tax advice.


Notice 2009-5 provides that tax return preparers may apply the substantial authority standard in the 2008 Tax Act, or may continue to rely on Notice 2008-13, which provides interim guidance.

3. **Tax Opinion Letters**

Whether to make disclosure is often a question of judgment. A tax opinion letter may state that a transaction “should” result in the tax consequences predicted if it possesses at least an eighty percent chance of success. Disclosure would not be required in this instance. However, if the tax treatment has only a “reasonable possibility of success,” disclosure should be made. Some tax advisors consider a forty percent chance of success the threshold below which disclosure should occur. Some transactions, although generating clear and favorable conclusions from a tax standpoint, will not have substantial authority solely because IRS never issued guidance. Those transactions would presumably not required disclosure. A tax opinion letter may state that a transaction “should” result in the tax consequences predicted if it possesses at least an eighty percent chance of success.
E. New York State Reporting Requirements

New York State imposes few special reporting requirements for like kind exchanges involving New York residents. New York imposes no withholding tax on exchange proceeds, except for nonresidents, who are subject to a 7.7 percent withholding tax. Nonresidents, who must generally make estimated payments, are required to check a box on Form IT-2663 and state that the transaction is a Section 1031 exchange. A single member LLC (SMLLC) that is ignored for federal income tax purposes is also ignored for New York State income tax purposes. However, since an LLC is a “person” as defined in Section 1101(b)(4) of the Tax Law, it may have an obligation to pay sales tax if it engages in a like kind exchange. New York imposes no special licensing, bonding or registration requirements on “qualified intermediaries” or “exchange accommodation titleholders” (discussed infra) that provide exchange services in New York. Finally, the acquisition of replacement property outside of New York State should not affect the tax-free nature of the exchange for New York tax purposes.

F. California’s “Clawback” Rule

Non-California residents should be aware of California’s “clawback” rule, which encourages only “one way” investments in California realty. Although California allows exchange treatment, deferred gain must continue to be reported indefinitely if out-of-state replacement property is acquired. If that property is ever sold in a taxable sale, California will “claw” its way back, and impose tax on the initial deferred gain. This would result in double state tax with respect to the later sale. Apparently the “clawback” rule cannot be avoided by investing in partnership interests. However, whether the clawback rule applies to corporations is less clear. The maximum income tax rate in California is 9.3 percent. Although some have suggested that California’s tax is an unconstitutional burden on interstate commerce, nothing in Section 1031 requires states to follow the federal like kind exchange regime, or to even provide like kind exchange treatment New York and other states are said to be considering such a rule. The rule is probably not unconstitutional, since no state is required to provide like kind exchange treatment as an initial matter.

1. Illustration

New York resident exchanges low basis Manhattan property for a tenancy

5 California, Maryland, New Jersey, South Carolina, Rhode Island and Vermont also impose a withholding tax on sales by nonresidents.

6 Interestingly, there is no California statute providing for this result. The rule is found in California Franchise Tax Board (FTB) publication 1100.
in common (TIC) interest in a Walgreens in Los Angeles in 2006. The taxpayer intends to “park” the exchange proceeds in the TIC investment until suitable permanent replacement property can be located. Two years later, the taxpayer engages in a second like kind exchange and acquires replacement property in Houston. **California continues to track the initial deferred gain from the exchange of the California property.** If the Houston property is ever sold, California will impose tax of 9.3 percent on the initial deferred gain, with the result that the sale would attract both California and New York income tax, with no possibility of credit from either state.\(^7\) Despite the rigor of California’s rule, there is no enforcement mechanism: California may never know when the later out-of-state property is sold. California is considering imposing continuing reporting requirements after the initial sale of the relinquished property.

\section*{G. Oregon Imposes Statutory Rule}

Oregon has imposed by statute a “clawback” rule similar to that imposed by California. Oregon requires continuing information return to be filed by nonresidents. Massachusetts imposes a clawback rule by regulation, as does Montana. To date, New York has not sought to impose a clawback rule.

\section*{H. Contrast Sale-Leaseback Transactions}

Suppose the taxpayer sells real property at a loss, and simultaneously enters into a long term lease of more than 30 years with respect to the same property. The IRS could assert the “sale” is a disguised like kind exchange, since real property is of like kind with leases in excess of 30 years. Regs. § 1.1031(a)-1(c). If the IRS were successful, the loss on the original sale would be disallowed, and payments received by the taxpayer would be recharacterized as boot. The IRS position would be weak if the rent called for under the lease were fair market value, since that would mean that the value of the lease was zero. If the lease has no value, it is difficult to see how it could be exchanged for real property, and recent cases have so held. *See Leslie Co. v. Com’r*, 64 T.C. 247 (1975), *nonacq.*, 1978-2 C.B. 3, *aff’d*. 539 F.2d 943 (3d Cir. 1976); *Crowley, Miller & Co. v. Com’r*, 76 T.C. 1030 (1981). However, if the lease does have value, the case law has held that a like kind exchange may indeed have occurred. *See Century Electric Co. v. Com’r*, 192 F.2d 155 (8th Cir. 1951).

\section*{I. Requirement That Taxpayer Be the Same}

\(^7\) Although, presumably both state taxes paid would be deductible for federal purposes. Mississippi and Vermont, also “nonconforming” states, require as a condition to deferring gain that the initial replacement property be located in-state. Georgia abandoned that rule.
Issues concerning the identity of the taxpayer or taxpayers engaging in a like kind exchange occasionally arise. To satisfy Section 1031, the taxpayer that disposed of relinquished property must be the same that acquires replacement property. For example, if husband and wife appear on the deed of the relinquished property, they must both take title to the replacement property. If only one name appears on the deed for the relinquished property, husband and wife may not take title to the replacement property in tenancy by the entirety (joint tenancy between husband and wife). This issue may also arise in circumstances involving (i) the death of the taxpayer; Rev. Rul. 64-161; Goodman v. Com’r., 199 F2d 895 (CA3 1952); or (ii) where property is held in trust; Rev. Rul. 92-105. The problem does not arise when a partnership exchanges property since, for this purpose, the partnership is viewed as an entity, and the entity, rather than the individual partners, engages in the exchange. TAM 9227002; TAM 9818003.

III. Qualified Use Requirement

A. Temporal Aspect

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 INVESTMENT IF SUCH PROPERTY IS EXCHANGED SOLELY FOR PROPERTY OF LIKE KIND WHICH IS TO BE HELD EITHER FOR PRODUCTIVE USE IN A TRADE OR BUSINESS OR FOR INVESTMENT. (EMPHASIS ADDED).

Therefore, an exchange of property acquired not for productive use, but rather for the purpose of engaging in a like kind exchange, would likely violate Section 1031(a)(1). Revenue Ruling 84-121. Even so, the Tax Court in Mason Est. v. Com’r, T.C. Memo 1988-273 held that exchanges by former partners of property received from their recently terminated partnerships did qualify for exchange treatment.

1. How Long Must Taxpayer Hold Property?

The word “held” means the property must be in the possession of the taxpayer for a definite period of time. Exactly how long has been the subject of considerable debate. PLR 8429039 stated that property held for two years satisfies the statute. However, it should be taxpayer’s intent that is actually determinative.
Therefore, an exchange of property that was actually held for productive use in a trade or business should qualify under Section 1031 even if it were held for considerably less than two years. Of course, evidencing the taxpayer’s intent for a short period of time might be difficult.

2. **No Requirement that Both Parties Seek Exchange Treatment**

No statute or regulation requires both parties involved in the transaction to seek like kind exchange treatment. Therefore, it would seem that an unrelated party may obtain real estate and immediately transfer it to another party who is seeking like kind exchange treatment. However, if related parties are involved, any gain deferred on the initial exchange will recognized as of the date either party disposes of property acquired in the initial exchange if that disposition occurs within 2 years of the date of the initial exchange. Section 1031(f)(1).

3. **Exchange of Investment Property for Business Property**

Property held for productive use in a trade or business and property held for investment are synonymous for purposes satisfying the qualified use requirement. Thus, property held for productive use in a trade or business may be exchanged for property to be held for productive use in a trade or business property or for property to be held for investment, and vice versa. Regs. § 1.031(a)-1(a)(1).

**B. Attributing Entity’s Qualified Use to Taxpayer**

The IRS may be unwilling to attribute an entity’s “qualified use” to the taxpayer after a transfer of the property from the entity to the taxpayer. In Revenue Ruling 77-337, the IRS found the “qualified use” requirement violated where the taxpayer received the relinquished property in a liquidating distribution from his wholly owned corporation and then immediately engaged in an exchange. However, the Ninth Circuit in *Bolker v. Com’r*, 81 T.C. 782 (1983), aff’d, 760 F2d 1039 (9th Cir. 1985), in similar circumstances, upheld exchange treatment where the relinquished property had been received in a tax-free liquidating distribution from the taxpayer’s wholly owned corporation on the same day the taxpayer entered into a Section 1031 exchange agreement. The court found significant the fact that the relinquished property was not held by the taxpayer for sale or for personal use, but was intended to be, and actually was, exchanged three months later for similar property. This implied an investment purpose.

1. **Relaxing of IRS Position on Qualified Use**
In PLR 200521002, the IRS issued a favorable ruling where a trust entered into an exchange with the intention to terminate and distribute the replacement property to trust beneficiaries. The “held for” requirement was satisfied since the IRS viewed the distribution and exchange as wholly independent.

2. **PLR 200812012 – Further Relaxing on Qualified Use**

In PLR 200812012, under the terms of Decedent’s will, Trust A was established to administer estate assets. The trust owned real property assets in various states which were held for investment. Under the terms of Decedent’s will, Trust A terminated. Pursuant to a Termination Plan formulated by Trustees, Trust A assets were contributed to an LLC. The issue raised in the ruling was whether the LLC could engage in a like kind exchange. The IRS ruled favorably, noting that Trust A terminated involuntarily by its own terms after many years in existence. The ruling also noted that there was no change in beneficial ownership of the LLC, or the manner in which it holds or manages the replacement property. The ruling distinguished Rev. Rul. 77-337, which involved “voluntary transfers of properties pursuant to prearranged plans.”

3. **Distribution of Replacement Property**

In *Maloney v. Com’r*, 93 T.C. 89 (1989), the Tax Court held that a liquidating distribution of the replacement property to the controlling shareholder a month after an exchange did not violate the “qualified use” requirement, since the remaining shareholders continued to have an economic interest in essentially the same investment. Moreover, the taxpayer had not “cashed in” his investment.

C. **Attributing Taxpayer’s Qualified Use to Entity**

*Magnesson v. Com’r*, 753 F.2d 1490 (9th Cir. 1985), *aff’d* 81 T.C. 767 (1983) held that a contribution of replacement property to a partnership following an exchange did not violate the qualified use requirement, even if the replacement property had been acquired with the intention of contributing it to a partnership. The court reasoned that the change in ownership did not significantly affect control of the property. However, Revenue Ruling 75-292 found the qualified use requirement violated where the taxpayer transferred replacement property to its wholly owned corporation immediately following the exchange. Can Revenue Ruling 75-292 be distinguished from *Magnesson*? Perhaps. While the IRS was not willing to impute the corporation’s qualified use to
the taxpayer, the Ninth Circuit, viewing the partnership under the aggregate theory, was apparently willing to impute the partnership’s qualified use to the taxpayer.

D. Disregarded Entities

The taxpayer may insist that replacement property be held by an entity possessing personal liability protection. Similarly, lenders financing replacement property may insist that the borrower form a single purpose “bankruptcy remote entity” to acquire the replacement property. Grantor trusts, business trusts, Illinois land trusts, and single member LLCs (SMLLCs) have been used to accomplish this purpose. Under Regs. § 301.7701-3, a single-owner entity, other than a corporation, will be disregarded for federal income tax purposes unless it elects to be taxed as a corporation.

1. Limited Liability Companies

a. Single Member LLC

The “qualified use” requirement seemed to preclude transferring newly-acquired replacement property to an LLC immediately following an exchange. However, property owners may now under Regs. § 301.7701-3 form single member LLCs (SMLLCs) owned by them to insulate themselves from potential liability. Since a SMLLC is ignored for income tax purposes, transferring newly-acquired replacement property into a SMLLC should not violate the qualifying use requirement of Section 1031. PLR 9807013 confirmed this premise, stating that a SMLLC may purchase replacement property or be the transferee of replacement property. The ruling diminished concerns that the disregarded entity might “poison” the exchange, by reason of (i) its being a different entity from that which transferred the relinquished property and (ii) the immediate transfer to the SMLLC violating the qualified use requirement.

b. Two-Member LLC

PLR 199911033 stated that even a two-member Delaware LLC would be disregarded for federal income tax purposes where (i) under Delaware law, a member need not possess any interest in capital and (ii) the sole purpose of the second member is to serve as a control check against bankruptcy filings or other actions that
would cause the LLC to violate covenants with its lenders. In the ruling, the taxpayer possessed all profits, losses and capital interests in the LLC. Since the second member of the LLC did not enter into the LLC agreement with the intent to operate a business and share profits, the LLC would not be treated as a partnership for federal income tax purposes.

2. **PLR 200908005 – Substituted Qualified Intermediaries**

   In PLR 200908005, the IRS ruled that the conversion of three subchapter S corporations, which engaged in the business of acting as a qualified intermediaries for like kind exchanges, to C corporations, would not be considered a change in the qualified intermediaries, despite the formation of three new taxpayer entities. The IRS reasoned that although the C corporation would no longer be a disregarded entity under federal tax law, the three entities would be the same for state law purposes, and there would be no change in the manner in which the corporations conducted business. This ruling leaves open the question of how the IRS would view the acquisitions of a bankrupt or insolvent qualified intermediary by another entity.

E. **Acquiring All Interests of Disregarded Entity**

1. **PLR 200118023**

   PLR 200118023 stated that the acquisition of all interests of an entity disregarded under Regs. § 301.7701-(2), which entity itself owns like kind property, constitutes the receipt of qualifying replacement property (provided the SMLLC has not elected to be taxed as a corporation for federal tax purposes).

2. **PLR 200807005**

   In PLR 200807005, taxpayer, a limited partnership, intended to form a wholly-owned LLC which would be a disregarded entity for federal tax purposes which will acquire 100 percent of the interests of the partners in a partnership in a like kind exchange. After the exchange, the LLC would be a general partner and the taxpayer a
limited partner in the partnership following the exchange. The ruling raised two issues: First, does the exchange qualify for nonrecognition under IRC § 1031? The ruling answered this in the affirmative. Pursuant to Rev. Rul. 99-6, the partnership is considered to have terminated under IRC §708(b)(1)(A), and made a liquidating distribution of its real property assets to its partners, and taxpayer is treated as having acquired those interests from the partners for federal tax purposes, rather than from the partnership. Accordingly, the transaction is a like kind exchange, rather than an exchange of partnership interests. The second issue raised was whether the taxpayer may hold the replacement property in a newly-created state law partnership that is disregarded for federal income tax purposes. Since the LLC is disregarded for tax purposes, and the taxpayer, who owns 100 percent of the partnership following the exchange, is considered as owning all of the real estate owned by the partnership, the ruling concluded that the taxpayer may hold the replacement property in a newly-created state law partnership that is disregarded for federal income tax purposes without violating the requirement of IRC § 1031 that replacement and relinquished property both must be held by the taxpayer in a trade or business or for investment.

F. Vacation Homes, Residences and “Qualified Use” Issues

1. Vacation Property Generally Ineligible for § 121 Exclusion

Gains from the sale of a vacation home will not qualify for the Section 121 exclusion, since the vacation home is not the taxpayer’s principal residence. Can a vacation home be exchanged under Section 1031? Although property held solely for personal use and enjoyment is not eligible for like kind exchange treatment, vacation property may be held for investment purposes and may therefore qualify for exchange treatment. See PLR 8508095. The Tax Court recently denied like kind exchange treatment for a vacation home used by the taxpayer but never rented. Barry E. Moore, T.C. Memo, 2007-134.

2. Revenue Procedure 2008-16 Safe Harbor

The issue of whether exchange treatment is available for vacation homes which are rented has been unclear. The report of the Treasury Inspector General for Tax Administrator (TIGTA) on September 17, 2007 determined that the IRS has
been remiss in its oversight of capital gains deferred through like kind exchanges. More than 338,500 Forms 8824, claiming deferred gains (or losses) of more than $73.6 billion, were filed for tax year 2004. The audit also found that regulations for exchanges involving vacation homes “are complex and may be unclear to taxpayers.” In response to the TIGTA mandate, the IRS issued Revenue Procedure 2008-16, which attempts to clarify situations in which vacation homes will qualify for like kind exchange treatment. Rev. Proc. 2008-16 establishes a “safe harbor” for determining whether a vacation home will meet the “for productive use in trade or business” requirement of Section 1031. The ruling applies to situations where the vacation home is both rented by the taxpayer to third parties, and also used by the taxpayer. The safe harbor will have been met if (i) the vacation home is owned continuously by the taxpayer throughout the qualifying use period; and (ii) within each of the two 12-month periods comprising the qualifying use period, the taxpayer must rent the vacation home to another person or persons at fair rental value for 14 days or more, and the period of the taxpayer’s personal use of the dwelling unit must not exceed the greater of 14 days or 10 percent of the number of days during the 12-month period that the dwelling unit is rented at fair rental value.

3. IRC § 280A May Govern by Analogy

Section 280A governs the deductibility of expenses other than real estate taxes and mortgage interest associated with vacation properties in which there is some personal use. It may by analogy provide insight as to whether vacation property is held for investment under Section 1031. Section 280A(d) states that a dwelling is a residence if personal use exceeds the greater of 14 days or 10 percent of the number of days the unit is rented at fair market value. The taxpayer could argue that the investment purpose requirement of Section 1031 is satisfied if personal use by the taxpayer falls below these thresholds.

4. Requirement That Property Be Held For “Investment”

Regs. § 1.1031(a)-1(b) provides that the term “investment” includes holding real property for future appreciation. Taxpayers contemplating an exchange of vacation property should document their intention to hold the property as an investment by maintaining accurate books and records. In addition, to meet the “qualified use” test, a vacation home should be held for a reasonable period of time (e.g., 12 months) prior to being disposed of in an exchange. While the property is being held, an attempt should be made to rent the property at fair market value to unrelated third parties. Finally, personal use should be kept to a minimum, and
should not exceed the periods prescribed by Section 280A.

5. **Coordination Between Sections 121 and 1031**

a. **Section 121**

Revenue Procedure 2005-14 coordinates Sections 121 and 1031 with respect to property used as both a personal residence and for business purposes. The Section 121 exclusion may be claimed even for the business portion of gain on mixed-use property, provided the office was a portion of a single structure. Furthermore, the Section 121 exclusion continues to apply even after property is converted entirely to business use. Although this result is not surprising, no guidance had previously been issued which confirmed this.

b. **Ordering Rules**

Revenue Procedure 2005-14 provides ordering rules for applying Sections 121 and 1031. The Section 121 exclusion is applied before applying Section 1031. This ordering rule is helpful, since the exclusion provided by Section 121 is generally preferable to the deferral provided by Section 1031. The boot recognition rule is also relaxed in that boot received is taxed only if and to the extent gain on the business portion of the single-dwelling unit is not excluded under Section 121.

IV. **Determining Whether Replacement Property is of “Like Kind”**

A. **Exchanges Involving Real Estate Enjoy Rarefied Status**

Determining whether particular property is of “like kind” necessitates a review of IRS pronouncements, decisional case law, and the Regulations. The Regulations provide that the words “like kind”

[H]AVE REFERENCE TO THE NATURE OR CHARACTER OF THE PROPERTY AND NOT TO ITS GRADE OR QUALITY. ONE KIND OR CLASS OF PROPERTY MAY NOT BE EXCHANGED FOR PROPERTY OF A DIFFERENT
KIND OR CLASS. \textbf{[However,]} WHETHER ANY REAL
ESTATE INVOLVED IS IMPROVED OR UNIMPROVED
IS NOT MATERIAL, FOR THAT FACT RELATES ONLY TO
THE GRADE OR QUALITY OF THE PROPERTY AND NOT
TO ITS KIND OR CLASS. (EMPHASIS ADDED). REGS. §
1.1031(a)-1(b).

As the Regulations state, exchanges involving real estate enjoy special status. Regs. §1.1031(a)-1(c) further provides that the exchange of a fee interest with a 30 year lease, or the swap of city real estate for a ranch or farm, are exchanges of “like kind” property. The exchange of a fee interest for coop shares would also appear to qualify under Section 1031. \textit{See also} PLR 943125, stating that a lot held for investment is of like kind with a townhouse to be used as rental property.

1. \textbf{Revenue Ruling 67-255}

Revenue Ruling 67-255 stated that a building is not of like kind to a building and land. It may therefore be difficult to strip a building from the underlying land and engage in an exchange. However, if the building includes an easement or lease, the building and lease might together qualify as real property for purposes of a like kind exchange.

2. \textbf{Foreign Real Estate Not of “Like Kind” to Domestic Real Estate}

Section 1031(h)(1) provides that “[r]eal property located in the United States and real property located outside the United States are not property of a like kind.” Although nonresidents may engage in like kind exchanges, Section 1031 applies only to exchanges of United States property interests for interests in property the sale of which would be subject to United States income tax. Section 897 provides for the treatment of gain or loss realized by a nonresident individual or foreign corporation who disposes of a United States real property interest. Section 1445 (subject to some exemptions) requires withholding of 10 percent of the amount realized in a transaction subject to Section 897.

3. \textbf{Ruling Expands Scope of Real Property}

Revenue Ruling 2004-86 expanded the scope of “like kind” real property by finding that real property and interests in a Delaware Statutory Trust which itself owns real property are of like kind. This result occurs because the owner of an interest in a Delaware Statutory Trust (DST), which is a grantor trust, is treated as
owning assets which are owned by the trust. Therefore, such an exchange actually consists of the exchange of real property interests, rather than the exchange of a real property interest for a certificate of trust that would be barred under Section 1031(a)(2)(E).

4. **New York Coops Are Real Property**

The IRS blessed the exchange of cooperative shares in PLR 200631-12. While acknowledging that “New York case law might suggest that there are conflicts concerning whether a cooperative interest in real property is real property [citations omitted],” the Ruling remarked that “various New York statutes treat an interest in a cooperative as equivalent to an interest in real property.” Accordingly, the Ruling held that interests in cooperative apartments in New York are of like kind improved and unimproved realty.

5. **Development Rights Real Property Interests**

PLR 200901020 ruled that development rights qualified as real property for purposes of Section 1031. In the facts of the ruling, property owner contracted to sell (relinquish) certain parcels of property. The contract contained a “put” option, which entitled the seller to transfer some of all of its residential development rights under a phased development plan. If the option was exercised, the buyer was required to sell certain hotel development rights back to the seller. After determining that the development rights constituted real property under state law, the PLR then stated that the development rights would qualify as like kind property if the rights were in perpetuity, and were directly related to the taxpayer’s use and enjoyment of the underlying property. The ruling concluded that the taxpayer had met these criteria.

6. **PLR 200842019 – Exchange of Leaseholds**

a. **Facts.** In PLR 200842019, the taxpayer exchanged an existing leasehold interest for a new lease. An understanding was reached between the taxpayer and the existing landlord for the taxpayer to engage in a like kind exchange with a qualified intermediary following construction of the taxpayer’s new leasehold. Upon completion of the leasehold improvements, the following events would occur: (i) the taxpayer would transfer the current lease
(together with leasehold improvements and office equipment) to QI; (ii) QI would transfer the current lease to taxpayer’s current landlord; (iii) QI would enter into a new lease with the new landlord; and (iv) QI would transfer the new lease (with leasehold improvements and office equipment) to the taxpayer, and the taxpayer would become a party to the new lease and assume all obligations under the new lease. The taxpayer’s current landlord would be required to provide funds for construction of leasehold improvements for premises under New Lease. New landlord would enter into a construction contract with independent construction company to construct leasehold improvements at taxpayer’s direction. Taxpayer would be required to provide assurances to New landlord.

b. Ruling & Analysis.

(1) **Like Kind Determination.** Leasehold interest with permanent improvements is of like-kind to another leasehold interest with permanent improvements. Variations in value or desirability relate only to the grade or quality of the properties and not to their kind or class. Depreciable tangible personal property is of like kind to other depreciable tangible personal property in the same General Asset Class. In this case, all of the depreciable personal property to be exchanged, i.e., office furniture, fixtures and equipment, is in the same General Asset Class.

(2) **Build-to suit Considerations.** Regs. § 1.1031(k)-1(e)(1) provides that the transfer of relinquished property will not fail to qualify for nonrecognition under § 1031 merely because replacement property is not in existence or is being produced at the time the property is identified as replacement property.

(3) **Basis Considerations.** Treas. Regs. §1.1031(j)-1(c) sets forth the exclusive method of basis computation for properties received in multiple property exchanges. In such exchanges, the aggregate basis of properties received in each of the exchange groups is the aggregate adjusted basis of the properties transferred by the taxpayer within that exchange group, increased by the amount of gain recognized by the
taxpayer with respect to that exchange group, with other adjustments. The resulting aggregate basis of each exchange group is allocated proportionately to each property received in the exchange group in accordance with its fair market value. Therefore, the basis of property received by the taxpayer will be determined on a property-by-property basis beginning by first ascertaining the basis of each property transferred in the exchange and adjusting the basis of each property in the manner provided in § 1.1031(j)-1(c).

(4) Receipt of Boot. Even if no cash is received in an exchange involving multiple properties, it is possible that boot will be produced, because property acquired within an exchange group may be of less value than property relinquished within that exchange group.

B. Exchanges of Tangible Personal Property Limited

In contrast to exchanges involving real property, exchanges of tangible personal property will qualify under Section 1031 only if the properties bear a strong resemblance to one another. In making this determination, the “similar or related in service or use” test of Section 1033(a)(1), rather than the rules developed for determining whether real estate is of like kind, appears to be the standard called for in the Regulations. Revenue Ruling 82-166 states that gold bullion and silver bullion are not of like kind since “silver and gold are intrinsically different metals . . . used in different ways.” Regs. § 1.1031(a)-2 provides that depreciable tangible personal property qualifies for exchange treatment if the properties are of “like kind” or “like class.” Properties are of “like class” if on the exchange date they are of the same (i) “General Asset Class” or (ii) “Product Class.” Regs. § 1.1031(a)-2(b)(2) provide a list of thirteen General Asset Classes. The SIC codes for Product Classes have been replaced by the North American Industrial Classification System (NAICS) with respect to exchanges after August 13, 2004. Exchanges involving nondepreciable personal property (e.g., a Van Gogh for a Monet) would involve a facts and circumstances inquiry.

1. General Asset Classes

Under Regs § 1.1031(a)(2)(b)(2), a light general purpose truck is not of the same General Asset Class as a heavy general purpose truck. Nor is a computer of the same General Asset Class as office furniture (or equipment). However, an automobile and a taxi are of the same General Asset Class, as are noncommercial
airplanes (airframes and engines) and “all helicopters.” The origin of the regulations appears to be Revenue Procedure 87-56, which lists assets classes for purposes of depreciation.

2. **Product Classes**

   a. **Former Classification Method**

      Product Class was formerly determined by reference to the 4-digit Standard Industrial Classification (SIC) codes published in the Office of Management and Budget’s SIC Manual, modified every five years. Any 4-digit product class ending in a “9” (i.e., a miscellaneous category) will not be considered a Product Class. If property is listed in more than one Product Class, the property is treated as though listed in any of those Product Classes. Regs § 1.1031(a)-2(b)(3).

   b. **Present Classification Method**

      The SIC codes for Product Classes have been replaced by the North American Industrial Classification System (NAICS) and Manual with respect to exchanges after August 13, 2004. Regs. § 1.1031(a)-2(b)(3) (superseded). Under the new regime, the NAICS Manual provides that depreciable tangible property is listed within a 6-digit product class listed in the NAICS Manual. Categories contained in the NAICS Manual are narrower than in the SIC Manual formerly used.

3. **Properties may be of Like Kind Without Being of Like Class**

   In PLR 200912004, taxpayer operated a leasing business, in which the taxpayer purchases and sells vehicles as the leases terminate. The taxpayer implemented a like kind exchange program pursuant to which the taxpayer exchanges vehicles through a qualified intermediary under a master exchange agreement. The taxpayer proposes to combine into single exchange groups all of its cars, light-duty trucks and vehicles that share characteristics of both cars and light duty trucks, arguing that all such vehicles are of like kind under Section 1031. Ruling favorably, the IRS noted that although the taxpayer’s cars and light duty trucks are not of like
class, Treas. Regs. § 1.1031(a)-2(a) provides that an exchange of properties that are not of like class may qualify for non-recognition under Section 1031 if they are of like kind. Moreover, Treas. Regs. § 1.1031(a)(2)(a) provides that “in determining whether exchange properties are [of] a like kind no inference is to be drawn from the fact that the properties are not of a like class.” Thus, properties can be in different asset classes and still be of like kind.

4. Foreign Tangible Personal Property Not of Like Kind

Section 1031(h)(2) provides that personal property used predominantly in the United States is not of like kind to personal property used predominantly outside the United States. Predominant use is based on the 2-year period preceding the exchange, with respect to relinquished property, and the 2-year period following the exchange, with respect to replacement property. Section 1031(h)(2)(C).

C. Real Property Containing Personal Property

Some exchange property may itself be comprised of both real and personal property. For example, an exchange may involve an apartment building or restaurant that contains furniture, fixtures, equipment or other assets. Since real property cannot be exchanged for personal property, the IRS views such transactions as exchanges of multiple assets rather than exchanges of one economic unit. The properties transferred and properties received must be separated into “exchange groups” by matching properties of like kind or like class to the extent possible. After the matching process is completed, if non-like kind assets remain, gain recognition may be required with respect to those assets. Regs. § 1.1031(j)-1.

1. Determination of Whether Real or Personal Property

At times, it may be difficult to determine whether exchange property is real property or personal property. This determination of whether exchange property is real or personal property is based on the law of the state in which the property is located. Aquilino v. U.S., 363 U.S. 509 (1960); Coupe v. Com’r, 52 T.C. 394 (1969). Whether particular property exchanged constitutes real property or personal property is important, as the receipt of personal property where real property was relinquished would produce boot. Such a dispute arose in Peabody v. Com’r, 126 T.C. No. 14 (2006). In that case, the IRS argued a coal supply contract itself, not the mine supplying the coal, possessed most of the value of property being exchanged. Accordingly, IRS argued that upon the receipt of replacement property consisting of a gold mine, a good exchange occurred, but that since the supply
contract was not of like kind to the gold mine, the taxpayer received boot. However, the Tax Court ruled the right to mine coal and sell coal is inherent in the fee ownership, and the two cannot be separated. Thus, the exchange was held not to produce boot.

D. Exchanges of Intangible Property

Although like kind exchanges are most often associated with real property or tangible personal property (e.g., an airplane), exchanges involving intangible personal property, consisting of customer lists, going concern value, assembled work force, and good will may also occur. An exchange of business assets requires the transaction to be separated into exchanges of its component parts. Revenue Ruling 57-365, 1957-2 C.B. 521. Unlike the case involving exchanges of real property or tangible personal property, no regulatory guidance is provided for exchanges of intangible property. Whether such an exchange qualifies under Section 1031 is therefore reduced to an inquiry as to whether the exchanged properties are of “like kind” under the words of the statute itself. In published rulings, the IRS has imported concepts from the regulations dealing with real property exchanges. As might be surmised, exchanges of intangible personal property are at times problematic.

1. Nature and Character of Rights Determinative

Regs. § 1.1031(a)-2(c) provides that whether intangible personal properties are of like kind depends on the nature and character of (i) the rights involved and (ii) the underlying property to which the intangible personal property relates. The Regulations take the position that the goodwill or going concern value of one business can never be of like kind to the goodwill or going concern value of another business. Therefore, such exchanges would always produce boot. The Regulations state that a copyright on a novel is of like kind to a copyright on another novel. However, a copyright on a song is not of like kind to a copyright on a novel since, although the rights are identical, the nature of the underlying property is substantially different. The objective in an exchange of businesses will therefore be first to demonstrate that the intangible assets being swapped do not consist of goodwill. The taxpayer must then demonstrate that both the rights and the underlying properties involved are also of like kind.

a. Taxpayer Assistance Memorandum (TAM 200035055)

TAM 200035055 stated that the exchange of a radio license for a television license qualified for exchange treatment. The rights involved, and the property to which the rights related, involved
differences only in “grade or quality,” rather than in their “nature or character.” Both licenses enabled the licensee to broadcast programming over the electromagnetic spectrum, making the rights “essentially the same.” The underlying property related to the use of the radio transmitting apparatus rather than the apparatus itself. The ruling concluded that although the bandwidth of radio and television broadcasts are different, those differences constituted differences only in grade or quality, rather than differences with respect to nature or character.

b. TAM 200602034 More Restrictive

Recently issued TAM 200602034 takes a more restrictive view of exchanges involving intangible personal property, stating that the rule for intangibles is “still more rigorous” than for tangible personal property. The rationale for this conclusion appears questionable.

2. CCA 200911006 – Trademarks Qualify as Like Kind Property

The IRS recently reversed its long held position that intangibles such as trademarks, trade names, mastheads, and customer based intangibles could not qualify as like kind property under Section 1031. Chief Counsel Advisory 20091106 states that these intangibles may qualify as like kind property provided they can be separately valued apart from a business’s goodwill, and that except in “rare or unusual circumstances” they should be valued apart from goodwill. Even so, the “nature and character” requirements of Treas. Regs. § 1.1031(a)(2)(c)(1) must still be met. Thus, not all trademarks, trade names and mastheads are of like kind to other trademarks, trade names and mastheads. CCA 20091106 opens up new planning opportunities for business owners seeking to swap similar businesses. Business owners may now defer gain not only with like-kind or like-class tangible assets, but also with like-kind non-goodwill intangibles disposed of in an exchange. Utilizing a “reverse exchange,” taxpayers may “park” non-goodwill intangibles with an Exchange Accommodation Titleholder (EAT), and use the parked property as part of a like-kind exchange within 180 days.
V. Basis of Property Received in Exchange

Section 1031(d) and the Regulations provide that the basis of property received in an exchange equals the aggregate basis of property transferred decreased by

(i) cash received;
(ii) liabilities associated with the relinquished property; and
(iii) loss recognized on the transfer of nonqualifying property

and increased by

(i) cash notes or notes transferred in the exchange;
(ii) the adjusted basis of any nonqualifying property transferred;
(iii) gain recognized on the transfer of nonqualifying property; and
(iv) liabilities associated with the replacement property.

A. Illustration of Basis Allocation Where Boot Received in Exchange

Basis is allocated first to nonqualifying property to the extent of its (or their) fair market value(s). Remaining basis is then allocated to nonrecognition properties in proportion to their respective fair market values. Section 1031(d). Taxpayer exchanges a building, with an adjusted basis of $500,000, a fair market value of $800,000, and subject to a mortgage of $150,000, for consideration consisting of (i) a vacant lot worth $600,000; (ii) $30,000 in cash; and (iii) a Picasso sketch worth $20,000. Realized gain (AR - AB) equals $300,000 [($600,000 + $150,000 + $30,000 + 20,000) - $500,000]. Since the debt relief of $150,000 is considered as cash received, $200,000 of nonqualifying property has been received. Realized gain of $300,000 must be recognized to the extent of the $200,000 of nonqualifying property (boot) received. This results in $100,000 of realized gain being deferred. Basis calculations are as follows:

1. Basis of Relinquished Building ............... $ 500,000
2. Basis Increase: Gain Recognized ............ $ 200,000

3. Basis Decreases:
   a. Money Received ......................... $ 30,000
   b. Debt Relief ............................... $ 150,000
   Total Basis Decreases ...................... $ 180,000

4. Basis of Relinquished Building ............... $ 500,000
   Plus: Basis Increase ........................ $ 200,000
   Minus: Basis Decreases ........................ $ 180,000
   Total Basis to be Allocated .................. $ 520,000

5. Allocation of Basis

<table>
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<th>Allocated</th>
<th>Remaining</th>
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<tr>
<td>Total Basis to Be Allocated ................ $520,000</td>
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</tr>
<tr>
<td>First: To Picasso Sketch to extent of FMV $20,000</td>
<td>$500,000</td>
</tr>
<tr>
<td>Next: Remainder of Basis to Land .......... $500,000</td>
<td>-0-</td>
</tr>
</tbody>
</table>

Note: If one year following the exchange the vacant lot which is still worth $600,000 and the Picasso sketch which is still worth $20,000 are both sold, the Picasso sale will produce no gain, but the land sale will generate $100,000 in recognized gain, which corresponds to the deferred gain from the initial exchange.

B. Holding Period

The holding period of qualifying property transferred is “tacked” onto the holding period of qualifying property received in the exchange. However, the holding period of boot received in the exchange begins anew. IRC Section 1223(1).

C. Transfers Involving Multiple Assets

1. Prior to Multiple Asset Exchange Regulations

Prior to the multiple asset exchange regulations of § 1.1031-1(j), where multiple assets were transferred and both had potential realized gain or loss, to calculate the nature and character of gain, boot was allocated between the assets transferred in accordance with fair market value. In an exchange involving relinquished property consisting of (i) a jet held for 5 months with an adjusted basis of $3.7 million and fair market value of $4 million and (ii) a train held for 2 years with an adjusted basis of $1 million and fair market value of $2 million, if replacement property consisting of another jet and $1 million cash, realized and recognized gain would have been calculated as
follows.

**Jet**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
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</thead>
<tbody>
<tr>
<td>Amount Realized</td>
<td>$4.0 million</td>
</tr>
<tr>
<td>Basis of Jet transferred</td>
<td>$3.7 million</td>
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<tr>
<td>Gain Realized</td>
<td>$0.3 million</td>
</tr>
<tr>
<td>Boot Allocable</td>
<td>$0.667 million</td>
</tr>
<tr>
<td>Gain Recognized</td>
<td>$0.3 million</td>
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<tr>
<td>Character of Gain:</td>
<td>Ordinary</td>
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**Train**

<table>
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<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amount Realized</td>
<td>$2.0 million</td>
</tr>
<tr>
<td>Basis of Train transferred</td>
<td>$1.0 million</td>
</tr>
<tr>
<td>Gain Realized</td>
<td>$1.0 million</td>
</tr>
<tr>
<td>Boot Allocable</td>
<td>$0.333 million</td>
</tr>
<tr>
<td>Gain Recognized</td>
<td>$0.333 million</td>
</tr>
<tr>
<td>Character of Gain:</td>
<td>§1231</td>
</tr>
</tbody>
</table>

**Note:** Even though boot of $1 million was received, and overall realized gain equals $1.3 million, gain recognized would only have totaled $0.633 million. This favorable result occurred because prior to the multiple asset exchange regulations, the application of Section 1031 occurred on a property-by-property basis. Here, the jet produced only $0.3 million in realized gain.

2. **Multi-Asset Exchange Regulations**

   **a. Definition of Multiple Asset Exchanges**

   For multiple asset exchanges after April 11, 1991, the multiple asset exchange rules of Regs § 1.1031(j)-1 apply. A multiple asset exchange is an exchange in which (i) more than one exchange group is created or (ii) only one exchange group is created but more than one property is being transferred or received within that exchange group. Regs. § 1.1031(j)-1(a)(1).

   **b. Calculation of Gain and Basis**
In general, the amount of gain recognized in an exchange of multiple properties is computed by first separating the properties transferred and the properties received into “exchange groups.” Next, all liabilities assumed in an exchange are offset by all liabilities of which the taxpayer is relieved in the exchange. Then, the rules of Section 1031 are applied separately to each exchange group to determine the amount of gain recognized in the exchange. Finally, the rules of Section 1031 and the regulations are applied separately to each exchange group to determine the basis of properties received in the exchange. Regs. § 1.1031(j)-1(a)(2) Resulting “exchange group deficiencies” would lead to less favorable boot gain results than would be the case prior to the multiple asset regulations.

VI. Gain or Loss in Like Kind Exchange

A. Realized Gain Recognized to Extent of Boot Received

Realized gain equals the sum of money and the fair market value of property received in the exchange less the adjusted basis of property transferred. Regs. § 1.1001-1(a). Realized gain is recognized to the extent of the sum of money and the fair market value of nonqualifying property received.\(^8\) Section 1031(b). Thus, if property with a fair market value of 10x dollars and basis of zero is exchanged for property with a fair market value of 5x dollars and 5x dollars in cash, realized gain of 10x dollars is recognized to the extent of the 5x dollars in cash received. Although basis would be increased by 5x dollars to reflect gain recognized, basis would also be decreased by 5x dollars to reflect cash received. Therefore, basis in the replacement property would be zero.

1. Debt Relief Treated as Cash Received

If liabilities associated with the relinquished property are assumed by the other party to the exchange, the taxpayer is deemed to receive cash. Section 1031(d); Regs. § 1.1031(b)-1(c); Coleman v. Com’r, 180 F2d 758 (8th Cir. 1050). Whether another party to the exchange has assumed a liability of the taxpayer is determined under Section 357(d).

\(^8\) Boot equals the sum of cash and the fair market value of “other property” (i.e., nonqualifying property) received in the exchange. “Other property” is defined as all property, excluding cash and property permitted to be received without recognition of gain. Regs. § 1.1031(b)-1.
2. **Compare: Realized Loss Not Recognized**

Although realized gain is recognized to the extent nonqualifying property is received in an exchange, Section 1031(c) provides that realized loss with respect to relinquished exchange property is never recognized, even if nonqualifying property is received in an exchange. *However, this does not mean that loss will never be recognized in a like kind exchange.* Under Section 1001(c), both gains and losses are recognized with respect to nonqualifying property transferred in a like kind exchange. Section 1031 takes a restrictive view of nonqualifying property received in an exchange, since it undermines the purpose of the statute. However, Section 1031 imposes no special rules with respect to the transfer of nonqualifying property in a like kind exchange.

a. **Illustration**

Taxpayer exchanges property in Florida which has declined in value, for an oil and gas lease in Montana, and cash. Realized loss with respect to the Florida property is not recognized because loss is not recognized with respect to the transfer of qualifying property, even if boot is received. However, if as part of the consideration for the Montana property the taxpayer also transferred Ford stock which had declined in value, realized loss on the Ford stock would be recognized (whether or not the taxpayer received cash boot) because both gains and losses are recognized with respect to the transfer of nonqualifying property in a like kind exchange.

3. **Boot Gain Taxed In Year Received**

When cash boot is received in a deferred exchange covering two taxable years, taxable income is presumably not recognized until the second year, when boot is received. *See* Revenue Ruling 2003-56.

**B. Generally No Gain if Taxpayer “Trades Up”**

Where a taxpayer “trades up” by acquiring property more valuable than the property relinquished and no boot is received, Section 1031 operates to defer recognition of all realized gain, (except in unusual circumstances involving depreciation recapture under Section 1245). However, if the taxpayer “trades down” and acquires property less valuable than that relinquished (thereby receiving cash or other nonqualifying property in the exchange) like kind exchange status will not
(for this reason) be imperiled, but the taxpayer will be forced to recognize some of the realized gain. Boot may consist of property excluded from like kind exchange treatment (e.g., partnership interests) or simply property which fails to constitute property that is of like kind to the property relinquished in the exchanged (e.g., a truck for a horse). Even if no nonqualifying property is received in the exchange, the IRS has taken the position that an exchange of real estate whose values are not approximately equal may yield boot. See PLR 9535028. This could occur, for example, in a situation involving the exchange of property among beneficiaries in the administration of an estate.

C. Boot Given in Like Kind Exchange

Transferring nonqualifying property along with qualifying property will not take a transaction out of Section 1031. However, consideration received must be allocated between the qualifying property and the nonqualifying property transferred in proportion to their respective fair market values. As noted above, consideration allocated to nonqualifying property transferred will result in gain or loss recognition under Section 1001(c). Regs. § 1.1031(d)-1(e). No gain or loss is recognized with respect to the transfer of cash, since no “sale or exchange” occurs.

1. Illustration Where Boot Given in Exchange

Taxpayer exchanges a building, with an adjusted basis of $1 million and a fair market value of $1.1 million, plus GM stock with an adjusted basis of $400,000 and a fair market value of $200,000, for a vacant lot with a fair market value of $1.3 million. The consideration of $1.3 million is allocated between the building and the GM stock in proportion to their fair market values. The taxpayer realizes gain of $100,000 on the building ($1.1 million - $1 million) and recognizes a loss of $200,000 under Section 1001(c) on the GM stock ($400,000 - $200,000). The gain realized from the exchange of the building for the vacant lot is not recognized because those properties are of like kind. The basis of the vacant lot is calculated as follows:

1. Loss on transfer of GM stock
   a. Adjusted Basis ......................................... $ 400,000
   b. Less: amount realized .............................. $ 200,000
   c. Loss realized and recognized ..................  $ 200,000

2. Adjusted basis of relinquished building ........... $ 1,000,000
   Plus: Adjusted basis of GM stock ............... $ 400,000
   Aggregate basis of property transferred ........ $ 1,400,000
3. Aggregate basis of property transferred .......... $ 1,400,000
   Less: Loss recognized on GM stock .............. $ 200,000
   Basis of vacant lot ............................................ $ 1,200,000

2. **Transaction Costs May Reduce Boot Gain**

   The receipt of cash or other nonqualifying property would normally produce taxable boot to the extent of realized gain. However, Revenue Ruling 72-456 provides that brokerage commissions and perhaps all transaction costs may offset boot. *Blatt v. Com’r*, 67 T.C.M. 2125; T.C. Memo (1994-48) held that expenses incurred in connection with the exchange and not deducted elsewhere on the taxpayer’s return offset boot. If transaction costs offset boot, the taxpayer may in effect “trade down.” *Blatt* suggested that the following expenses should be allowed as exchange expenses:

   a. Escrow fees;
   b. Fees in obtaining lender statement;
   c. Document preparation fees;
   d. Title insurance policy fees;
   e. Sub-title fees;
   f. Exchange tie-in fees;
   g. Recording deed fees;
   h. Recording reconveyance fees;
   i. Documenting fees for transfer tax;
   j. Statement fees;
   k. Reconveyance fees;
   l. Loan organization fees;
   m. Document preparation fees;
   n. Tax service fees;
   o. Processing fees;
   p. Messenger fees;
   q. Lenders title policy premium fees;
   r. Sub-escrow fees;
   s. Recording trust deed fees; and
   t. Loan tie-in fees.

   VII. **Treatment of Expenses and Transactional Items Related to Closing**
Precatory Note on Timing of Expense Payments:

Regs. §1.1031(k)-1(g)(7) permits typical closing expenses to be paid from exchange proceeds held by the qualified intermediary. However, if there is any doubt about the timing of the payment, the expense should not be paid until the closing of the replacement property, when the taxpayer would otherwise have the right to receive the funds. Otherwise, in a poor scenario, the payment by the QI during the exchange period could result in boot. In the worse scenario, the payment could take the transaction out of the safe harbor deferred exchange regulations entirely, resulting in constructive receipt by the taxpayer of the entire exchange proceeds, and nullify the like kind exchange.

TREATMENT OF EXPENSES AND TRANSACTIONAL ITEMS RELATED TO CLOSING ON THE RELINQUISHED PROPERTY

A. Selling Expenses Excluded From Amount Realized

The following items are deducted from the contract price in determining the amount realized. They affect realized gain only.

1. Broker’s commissions
2. Transfer taxes
3. Recording Fees
4. Attorney’s Fees
5. Qualified Intermediary Exchange Fee

B. Closing Costs or Transactional Expenses That May be Paid With Exchange Proceeds But Which Are Not Excluded From Amount Realized or Added to the Basis of Replacement Property

Rather, they are operating costs due to the ownership of real property. However, even though they may not affect calculations with respect to the like kind exchange (and may therefore not appear on Form 8824), they may be deductible elsewhere on the return. Examples of these items include the following:

1. Real estate taxes
2. Rent
3. Costs incurred to remove mechanic’s liens

C. Transactional Prorations Which Result in Boot Received When Relinquished Property is Sold

1. Credit to buyer for rents received allocable to period following the closing

   [The portion of the rent collected by the taxpayer for periods after the closing are credited to the buyer, but never pass to the qualified intermediary. Since the taxpayer-seller retains the cash, it is a clearly boot. However, if boot may be an issue in the exchange, the problem might be avoided if the taxpayer-seller prior to closing places the unearned rent into an escrow account which passes to the qualified intermediary.]

2. Credit due to buyer for prorated security deposits

   [The security deposits for which the buyer receives a credit at closing, constitute part of the purchase price of the real estate. If instead of crediting the buyer, the seller cut a check to the buyer at closing, more funds would be delivered to the QI. Since the cash remains in the account of the seller-taxpayer. If boot is not a problem in the transaction, the seller-taxpayer would likely prefer to keep the cash.]

3. Credit to buyer for repair costs

   [The seller might prefer to reduce the selling price. However, this might affect the buyer’s financing.]

4. Credit to buyer for accrued (unpaid) utility charges

   [The seller-taxpayer, although giving the buyer a credit, has received boot in the form of the relief of the liability. This is analogous to the boot gain resulting from the buyer’s assumption of a mortgage.]

5. Payoff for loan, including (i) principal balance; (ii) accrued interest through closing date; and (iii) prepayment penalty
6. Credit due to Buyer for Prorated Accrued Property Taxes

[Prorated accrued property taxes are treated as liabilities and reflect liability boot which may be offset with corresponding liabilities on the replacement property.]

D. Transactional Prorations Which Result in Boot Paid When Relinquished Property is Sold

1. Credit due to seller for escrow deposits with lender

[The purchase price is increased, which means that more cash is going to the QI]

2. Credit due to seller for prepaid service contracts

[Seller-taxpayer has paid post-closing liability in cash for which he was not responsible]

TREATMENT OF EXPENSES AND TRANSACTIONAL ITEMS RELATED TO CLOSING ON THE REPLACEMENT PROPERTY

A. Selling Expenses Excluded From Amount Realized

The following items are deducted from the contract price in determining the amount realized. They affect realized gain only.

1. Finder’s fees
3. Survey, unless solely for purposes of loan
3. Property inspection & environmental testing fees, unless solely for purposes of loan
4. Title insurance premiums (owner’s policy)
5. Recording fees
6. Attorney’s fees

B. Closing Costs or Transactional Expenses That May be Paid With
Exchange Proceeds But Which Are Not Excluded From Amount Realized or Added to the Basis of Replacement Property

Rather, they are operating costs due to the ownership of real property. However, even though they may not affect calculations with respect to the like kind exchange (and may therefore not appear on Form 8824), they may be deductible elsewhere on the return. Examples of these items include the following:

1. Real estate taxes
2. Rent
3. Costs incurred to remove mechanic’s liens

[Note: This is the same discussion as obtained with respect to the disposition of the relinquished property.

C. Transactional Prorations Which Result in Boot Paid When Replacement Property is Purchased

1. Credit to taxpayer-buyer for rents received by seller but allocable to periods following the closing

   [The portion of the rent collected by the seller for periods following the closing are credited to the taxpayer-buyer. The “property” paid by the taxpayer-buyer consist of the funds which remain the account of the seller. The seller could also refund these amounts, instead of issuing a credit on the closing statement. In either case, the taxpayer would have taxable income. However, if boot gain may be a problem, it would be preferable for the taxpayer-buyer to be credited, rather than receiving a refund, since the boot paid will offset boot received in the exchange.]

2. Credit due to taxpayer-buyer for prorated accrued property taxes

   [Prorated accrued property taxes are treated as liabilities assumed by the taxpayer-buyer, and may offset liabilities with respect to which the taxpayer was relieved on the relinquished property.]

3. Credit due to taxpayer-buyer for prorated security deposits

   [The security deposits for which the taxpayer-buyer receives a credit]
at closing would otherwise have been paid in cash. Since this item, if credited rather than received in cash, will constitute boot paid, it may be preferable for the taxpayer to take the credit rather than receive the cash, since the boot paid will offset boot received in the exchange.

D. Transactional Prorations Which Result in Boot Received When Replacement Property is Purchased

1. Credit due to seller for prepaid service contracts

   [Seller has paid post-closing liability in cash for the benefit of the taxpayer-buyer which results in boot]

2. Prepaid property casualty & liability insurance premium

   [Seller has paid a post-closing liability in cash for the benefit of the taxpayer which results in boot]

3. Prepaid per diem interest on loan

4. Title insurance (lender’s policy)

5. Appraisal fee

6. Loan origination fee

7. UCC search fees

ISSUES INVOLVING EARNEST MONEY DEPOSITS

A. Relinquished Property

   Problem of Deposit Being Paid to Taxpayer-Seller Directly. Deposit should never be paid to taxpayer directly! If the taxpayer has already deposited the earnest money check into his account, he should transfer the funds to the qualified intermediary when the relinquished property contract is assigned to the QI. Another approach would be for the taxpayer to return the funds to the prospective
buyer and then have the buyer cut another check to the QI. If the taxpayer has entered into an option agreement whereby the buyer paid for the right to purchase the relinquished property, the option payment will likely be considered boot.

Deposit Made to Taxpayer’s Attorney Acceptable. If, as is usually the case, the earnest money is held by the taxpayer’s attorney, the taxpayer should assign its rights to the earnest money, as well as all of its rights under the relinquished property contract, to the qualified intermediary.

B. Replacement Property

The qualified intermediary may properly make an earnest money deposit for replacement property, but only after the purchase and sale agreement for the replacement property has been assigned to the QI. Furthermore, the escrow instructions should provide that if the taxpayer does not close on the property, the deposit will be returned to the QI, and not the taxpayer.

If the taxpayer is already in contract for the purchase of the replacement property before the qualified intermediary is involved, the taxpayer will have made the deposit with his own funds. At some point, the qualified intermediary will become in possession of the exchange funds, and the taxpayer will also have assigned the rights to the replacement property contract to the qualified intermediary. It would clearly violate the deferred exchange regulations if the qualified intermediary reimbursed the taxpayer for the earnest money deposit prior to on the replacement contract. However, at that time, the qualified intermediary could properly reimburse the taxpayer from the exchange funds.

C. DISBURSEMENT OF EXCHANGE FUNDS

1. G-6 Limitations

Regs. §1.1031-1(k)-1(g)(6) govern the disbursement of funds to the taxpayer. The regulations provide that the exchange agreement must limit the taxpayer’s right to receive, pledge, borrow, or otherwise obtain the benefits of the proceeds prior to the expiration of the exchange period.

2. When Proceeds May be Disbursed

A. Excess Exchange Proceeds at Closing of Relinquished Property

The taxpayer may receive excess proceeds at the closing of the relinquished property, as long as those proceeds are not disbursed by the QI.
3. After Relinquished Property Closing but Prior to 46th Day.

If the taxpayer has closed on all identified replacement property prior to the 46th day, then excess exchange proceeds may be distributed after that time. If the taxpayer has identified no replacement property before the expiration of the 45-day identification period, then the exchange proceeds may be distributed on the 46th day.

4. After the 45th day Identification Period

If the taxpayer has identified property during the identification period, but decides after the 45th day that he will not acquire replacement property, the proceeds are frozen with the QI until after the 180-day exchange period. If the taxpayer has identified more than one property, and closes on one property either before or after the 45-day identification period, the remaining exchange proceeds will be frozen with the QI until after the exchange period.

5. Query: If taxpayer has funds left in the exchange account after the end of the identification period (if no identification is made) or at the end of the exchange period (if no or insufficient replacement property is acquired), can the remaining exchange funds be paid to the taxpayer over time and qualify for installment sale treatment? Special installment sale rules apply during the pendency of a like-kind exchange pursuant to Treas. Regs. § 1.1031(k)-1(j)(2). The “protection” terminates at the end of the exchange.

6. Like-Kind Exchange into Installment Sale?

As insurance against a failed like-kind exchange, at the time of the (g)(6) event, the QI gives an installment note to the taxpayer and assigns the obligation under the note to an unrelated assignment company. Assignment company may use funds to purchase an annuity from an insurance company to provide a funding source for the installment note. It is unclear whether this would qualify for installment sale treatment. Structures like this are being marketed as a fall back to a failed exchange.
HYPOTHETICAL

Wimbledon Investors, LLC, ("Wimbledon") owns an office building at 11111 Northern Boulevard, Great Neck, New York, that it has entered into a contract to sell for $10,000,000. The down payment of $1,000,000 is being held by the attorney for Wimbledon Investors, LLC in an attorney escrow account. Wimbledon has an adjusted basis in the office building of $5,420,000, so would have a capital gains tax liability in excess of $1 million were it to sell the property without engaging in a like kind exchange. Wimbledon has engaged JPMorgan Chase Bank ("Chase") as qualified intermediary ("QI"), and has assigned its rights under the relinquished property contract and the earnest money deposit to Chase. Wimbledon has an outstanding loan on the relinquished property to Citibank, NA whose outstanding principal balance is $4,748,345. The loan is cannot be assumed and is subject to a prepayment penalty.

Wimbledon has located potential replacement property, which consists of a commercial building situated at 1201 Skillman Avenue, Long Island City, New York. Wimbledon does not need to identify the replacement property; since it is acquired within the 45-day identification period, the “actual purchase” rule is satisfied. Wimbledon has signed a contract to acquire the Skillman Avenue property for $11,000,000. Wimbledon entered into the purchase and sale contract for the Skillman Avenue property prior to engaging Chase as QI. Accordingly, Wimbledon paid the $1,100,000 earnest money deposit from its own funds. Wimbledon would like to be reimbursed for this amount from the exchange funds at closing. Wimbledon assigned its rights in the replacement property contract to Chase as QI. Wimbledon will obtain financing for the acquisition of the replacement property from HSBC.

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9 An attorney may deposit an earnest money deposit into either an IOLA account, or into a segregated escrow account. While dealing with an IOLA account is simpler, interest is foregone. Therefore, if the attorney foresees that the funds will be held in the account for any significant length of time, they should be deposited into a regular attorney escrow account. The choice of which type of escrow account into which the earnest money should be deposited has no effect on the exchange.
### CLOSING STATEMENT – RELINQUISHED PROPERTY

SELLER: J.P. Morgan Exchange, Inc., as Qualified Intermediary for Wimbledon Investors, LLC, a New York Limited Liability Company

BUYER: Adirondack Properties, LLC

PROPERTY: Office Building at 11111 Northern Boulevard, Great Neck, NY 10021

DATE: December 15, 2008, 10:00 AM

---

**SUMMARY OF SELLER’S TRANSACTION**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Purchase Price</strong></td>
<td>$10,000,000</td>
</tr>
<tr>
<td><strong>Plus:</strong></td>
<td></td>
</tr>
<tr>
<td>Credit due to Seller for escrow deposits with lender</td>
<td>[BOOT PAID] $50,243</td>
</tr>
<tr>
<td>Credit due to Seller for prorated prepaid service contracts</td>
<td>[BOOT PAID] $13,387</td>
</tr>
<tr>
<td>Credit due to Seller for property taxes pd through 12/31/08</td>
<td>[BOOT PAID] $11,123</td>
</tr>
<tr>
<td><strong>Subtotal</strong></td>
<td>[BOOT PAID] $74,753</td>
</tr>
<tr>
<td><strong>Less:</strong></td>
<td></td>
</tr>
<tr>
<td>Earnest Money Deposit</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Credit due to Buyer for prorated (post-closing) rent</td>
<td>[BOOT RECEIVED] $20,000</td>
</tr>
<tr>
<td>Unpaid Accrued Utility Charges (liab. assumpt.)</td>
<td>[BOOT RECEIVED] $14,439</td>
</tr>
<tr>
<td>Credit due to Buyer for security deposits</td>
<td>[BOOT RECEIVED] $17,500</td>
</tr>
<tr>
<td>Payoff for Citibank Loan (receipt of cash)</td>
<td></td>
</tr>
<tr>
<td>Principal balance</td>
<td>[BOOT RECEIVED] $4,748,345</td>
</tr>
<tr>
<td>Accrued interest through closing date</td>
<td>[BOOT RECEIVED] $32,432</td>
</tr>
<tr>
<td>Prepayment penalty</td>
<td>[BOOT RECEIVED] $20,000</td>
</tr>
<tr>
<td>Broker’s Commission</td>
<td>[EXPENSE] $400,000</td>
</tr>
<tr>
<td>Attorneys’ fees</td>
<td>[EXPENSE] $10,000</td>
</tr>
<tr>
<td>Recording Fees</td>
<td>[EXPENSE] $140,000</td>
</tr>
<tr>
<td>Qualified Intermediary exchange fee</td>
<td>[EXPENSE] P.O.C. 10</td>
</tr>
<tr>
<td><strong>Subtotal</strong></td>
<td>$6,402,716</td>
</tr>
<tr>
<td><strong>Balance due Seller</strong></td>
<td>$3,672,037</td>
</tr>
<tr>
<td><strong>Funds delivered to Qualified Intermediary</strong></td>
<td>$4,672,037 11</td>
</tr>
</tbody>
</table>

10 Qualified Intermediary exchange fee of $1,000 paid out of closing; deducted from exchange funds after closing.

11 $3,672,037 balance due at closing plus $1,000,000 earnest money deposit.
CLOSING STATEMENT – REPLACEMENT PROPERTY

SELLER: Atlantis Properties, LLC, a New York Limited Liability Company
BUYER: J.P. Morgan Exchange, Inc., as Qualified Intermediary for Wimbledon
Investors, LLC, a New York Limited Liability Company
PROPERTY: Commercial building at 1201 Skillman Avenue, Long Island City, NY
DATE: December 28, 2008, 10:00 AM

<table>
<thead>
<tr>
<th>SUMMARY OF BUYER’S TRANSACTION</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purchase Price</td>
</tr>
<tr>
<td>$ 11,000,000</td>
</tr>
<tr>
<td>Less:</td>
</tr>
<tr>
<td>Credit due to Buyer for prorated rent collected by seller [BOOT PAID] $ 2,750</td>
</tr>
<tr>
<td>Credit due to Buyer for Seller’s for accrued property taxes [BOOT PAID] 13,387</td>
</tr>
<tr>
<td>Credit due to Buyer for security deposits retained by seller [BOOT PAID] 11,123</td>
</tr>
<tr>
<td>Earnest money deposit</td>
</tr>
<tr>
<td>1,100,000</td>
</tr>
<tr>
<td>Subtotal</td>
</tr>
<tr>
<td>$ 1,127,260</td>
</tr>
<tr>
<td>Plus:</td>
</tr>
<tr>
<td>Credit due to Seller for prorated prep service contracts [BOOT REC’D] $ 9,600</td>
</tr>
<tr>
<td>Credit to Seller for Prepaid per diem interest on loan [BOOT REC’D] 19,540</td>
</tr>
<tr>
<td>Credit to Seller for Prepd prperty casualty &amp; liab. ins. prem [BOOT REC’D] 9,500</td>
</tr>
<tr>
<td>Title insurance – lender’s policy [BOOT REC’D] 9,000</td>
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<tr>
<td>Appraisal fee [BOOT REC’D] 7,500</td>
</tr>
<tr>
<td>Loan Origination Fee [BOOT REC’D] 80,000</td>
</tr>
<tr>
<td>UCC search fees [BOOT REC’D] 275</td>
</tr>
<tr>
<td>Survey [EXPENSE] 2,000</td>
</tr>
<tr>
<td>Attorneys’ fees [EXPENSE] 10,000</td>
</tr>
<tr>
<td>Recording fees [EXPENSE] 150</td>
</tr>
<tr>
<td>Environmental study [EXPENSE] 6,500</td>
</tr>
<tr>
<td>Title insurance – owner’s policy [EXPENSE] 22,000</td>
</tr>
<tr>
<td>Qualified Intermediary exchange fee [EXPENSE] P.O.C.12</td>
</tr>
<tr>
<td>Subtotal</td>
</tr>
<tr>
<td>$ 176,065</td>
</tr>
<tr>
<td>Total due from Buyer</td>
</tr>
<tr>
<td>$ 10,048,805</td>
</tr>
<tr>
<td>Deposit from Qualified Intermediary</td>
</tr>
<tr>
<td>$ 3,571,03713</td>
</tr>
<tr>
<td>Balance due to Seller</td>
</tr>
<tr>
<td>– Loan proceeds from HSBC</td>
</tr>
<tr>
<td>$ 6,477,768</td>
</tr>
</tbody>
</table>

12 Qualified Intermediary exchange fee of $1,000 paid out of closing; deducted from exchange funds after closing.

13 Consists of $4,672,037 funds delivered to QI at relinquished property closing, less (i) $1,000 QI exchange fee and (ii) $1,100,000 earnest money deposit reimbursed to Buyer at closing.
<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Check: Net Credits to Seller:</td>
<td>$11,380</td>
</tr>
<tr>
<td>Purchase Price:</td>
<td>$11,000,000</td>
</tr>
<tr>
<td>Amt Due Seller w/credits</td>
<td>$11,011,380</td>
</tr>
<tr>
<td>Less: Deposit</td>
<td>$1,100,000</td>
</tr>
<tr>
<td>Net due Seller</td>
<td><strong>$9,911,380</strong></td>
</tr>
<tr>
<td>Total Due from Buyer:</td>
<td>$10,048,805</td>
</tr>
<tr>
<td>Less buyer expenses paid from escrow</td>
<td>$137,425</td>
</tr>
<tr>
<td>Total remaining for seller</td>
<td><strong>$9,911,380</strong></td>
</tr>
</tbody>
</table>
# Classification of Transactional Items

1. **Relinquished Property Exchange Expenses:**
   
<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Broker’s commission</td>
<td>$400,000</td>
</tr>
<tr>
<td>Recording fees</td>
<td>140,000</td>
</tr>
<tr>
<td>Attorneys’ fees</td>
<td>10,000</td>
</tr>
<tr>
<td>Qualified Intermediary exchange fee</td>
<td>1,000</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td><strong>$551,000</strong></td>
</tr>
</tbody>
</table>

2. **Relinquished Property Prorations and Other Transactional Items Treated as Boot Received by Seller:**
   
<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit due to Buyer for prorated rent kept by seller</td>
<td>$20,000</td>
</tr>
<tr>
<td>Credit due to Buyer for security deposits (deposits kept by seller)</td>
<td>17,500</td>
</tr>
<tr>
<td>Accrued utility charges (Liability assumed by buyer)</td>
<td>14,439</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td><strong>$51,939</strong></td>
</tr>
</tbody>
</table>

3. **Relinquished Property Prorations and Other Transactional Items Treated as Boot Paid by Seller:**
   
<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit due to Seller for escrow deposits with lender (cash foregone)</td>
<td>$50,243</td>
</tr>
<tr>
<td>Credit due to Seller for prorated prepaid service contracts (prepd liab.)</td>
<td>13,387</td>
</tr>
<tr>
<td>Credit due to Seller for property taxes paid through 12/31/08 (prepd liab.)</td>
<td>11,123</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td><strong>$74,753</strong></td>
</tr>
</tbody>
</table>

4. **Replacement Property Exchange Expenses:**
   
<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Title Insurance – owner’s policy</td>
<td>$22,000</td>
</tr>
<tr>
<td>Attorneys’ fees</td>
<td>10,000</td>
</tr>
<tr>
<td>Environmental study</td>
<td>6,500</td>
</tr>
<tr>
<td>Survey</td>
<td>2,000</td>
</tr>
<tr>
<td>Recording fees</td>
<td>150</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td><strong>$40,650</strong></td>
</tr>
</tbody>
</table>

5. **Replacement Property Loan Costs Treated as Boot Received by Buyer:**
   
<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Title Insurance – lender’s policy (cash otherwise wld have gone to QI)</td>
<td>$9,000</td>
</tr>
<tr>
<td>Appraisal fee</td>
<td>7,500</td>
</tr>
<tr>
<td>Loan origination fee</td>
<td>80,000</td>
</tr>
<tr>
<td>UCC search fees</td>
<td>275</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td><strong>$96,775</strong></td>
</tr>
</tbody>
</table>

6. **Replacement Property Prorations and Other Transactional Items Treated as Boot Received by Buyer:**
   
<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit due to Seller for prorated prepaid service contracts (prepd liab.)</td>
<td>9,600</td>
</tr>
<tr>
<td>Prepaid property and casualty liability insurance premium (prepd liab.)</td>
<td>9,500</td>
</tr>
<tr>
<td>Prepaid per diem interest on new loan</td>
<td>19,540</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td><strong>$38,640</strong></td>
</tr>
</tbody>
</table>

7. **Replacement Property Prorations and Other Transactional Items Treated as Boot Paid by Buyer:**
   
<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit due to Buyer for prorated rent received by seller (cash foregone)</td>
<td>2,750</td>
</tr>
<tr>
<td>Credit due to Buyer for Seller’s portion of accrued taxes (liab. assumed)</td>
<td>13,387</td>
</tr>
<tr>
<td>Credit due to Buyer for prorated security deposits (cash foregone)</td>
<td>11,123</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td><strong>$27,260</strong></td>
</tr>
</tbody>
</table>
DETERMINATION OF NET BOOT RECEIVED OR PAID

Netting of Prorations and Other Transactional Items:

Relinquished property prorations and other items treated as boot paid $ 74,753
Replacement property prorations and other items treated as boot paid 27,260
Less relinquished property prorations and other items treated as boot received (51,939)
Less replacement property loan costs treated as boot received (96,775)
Less replacement property prorations and other items treated as boot received (38,640)

Net boot paid (received) on prorations and transactional items $ (85,341)

Less relinquished property liabilities assumed that are treated as boot received:

   Principal balance of mortgage loan $4,748,345
   Accrued interest on mortgage loan 32,432
   Prepayment penalty on mortgage loan 20,000 (4,800,777)

Plus replacement property liabilities assumed

   New mortgage loan 6,477,768

Net boot paid (received) $1,591,650
GAIN REALIZED AND RECOGNIZED
ON SALE OF RELINQUISHED PROPERTY

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Selling Price of Relinquished Property</td>
<td>$10,000,000</td>
</tr>
<tr>
<td>Less selling/purchasing expenses</td>
<td></td>
</tr>
<tr>
<td>Selling expenses of relinquished property</td>
<td>$551,000</td>
</tr>
<tr>
<td>Purchase expenses of replacement property</td>
<td>$40,650</td>
</tr>
<tr>
<td>Net selling price of relinquished property (i.e., Amount Realized)</td>
<td>$9,408,350</td>
</tr>
<tr>
<td>Less adjusted basis of relinquished property</td>
<td>5,420,000</td>
</tr>
<tr>
<td>Gain Realized</td>
<td>A $3,988,350</td>
</tr>
<tr>
<td>Net boot received</td>
<td>B $ -0-</td>
</tr>
<tr>
<td>Gain Recognized – lesser of A or B</td>
<td>$ -0-</td>
</tr>
<tr>
<td>Deferred Gain</td>
<td>$3,988,350</td>
</tr>
</tbody>
</table>
### BASIS OF REPLACEMENT PROPERTY

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Basis of relinquished property</td>
<td>$5,420,000</td>
</tr>
<tr>
<td>Gain recognized</td>
<td>-0-</td>
</tr>
<tr>
<td>Add net boot paid</td>
<td>1,591,650</td>
</tr>
<tr>
<td><strong>Basis of replacement property</strong></td>
<td><strong>$7,011,650</strong></td>
</tr>
</tbody>
</table>

**Check:**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purchase price of replacement property</td>
<td>$11,000,000</td>
</tr>
<tr>
<td>Deferred gain</td>
<td>3,988,350</td>
</tr>
<tr>
<td><strong>Basis of replacement property</strong></td>
<td><strong>$7,011,650</strong></td>
</tr>
</tbody>
</table>
D. Transaction Costs May Be Expensed or Required to be Capitalized

1. Items Expensed

Transactional items may either be expensed or be capitalized into the basis of replacement property. Some expenses, such as transfer taxes or attorneys fees, are permitted to be expensed. Expensed items will not result in taxable boot. To illustrate, assume a selling price of $1 million, $10,000 of attorneys’ fees, and $100,000 in cash paid at the closing. Here, the “net selling price” would be $990,000. If the taxpayer’s basis in the property were $900,000, this would result $90,000 of realized gain, all of which would be recognized. Had the attorneys’ fee not been expensed, all of the $100,000 of realized gain would have been recognized. Put another way, even though the attorneys’ fees were paid by cash derived from exchange proceeds, $10,000 of that cash did not produce boot. Other selling expenses of this type include (i) broker or selling agent sales commissions; (ii) finder’s fees; (iii) inspection and testing fees; (iv) title insurance premiums; (v) escrow fees; (vi) transfer taxes; (vii) recording fees; and (viii) qualified intermediary exchange fees.

2. Items Capitalized

Some items paid at closing cannot be expensed, but they nevertheless can offset boot received in the exchange. To illustrate: assume in the above example that the closing occurred on June 1st, 2008, and that the seller had paid $100,000 for a service contract on January 1st effective for the entire year, but that no cash was paid at closing. The closing statement would reflect a credit to the seller for $50,000. The credit – even though an expense incurred by the seller in economic terms – would not reduce the “net selling price” as would attorneys’ fees. The realized gain in the transaction would be $100,000. However, the taxpayer could net the service contract credit (boot paid) with other boot received. For example, assume the seller collected rent of $100,000 on June 1st. This item would be reflected on the closing statement as a credit to the buyer and would be boot. However, since the seller also paid boot of $50,000, the two could be netted. After netting, a boot gain of $50,000 would result, which would incur capital gains tax. The basis of the replacement property would be increased by the $50,000 of gain recognized. The effect of the netting would be to permit the taxpayer to capitalize the transactional item into the basis of the replacement property. Other examples of items that must be capitalized include prorated rents and prorated taxes.

E. ABA Position on Boot Gain

The ABA Section of Taxation takes the position that virtually all kinds of expenses incurred in connection with the exchange, except expenses attributable to refinancing, should offset boot, regardless of whether they are attributable to the relinquished property or the replacement property.
The expenses allowed in *Blatt* seem to include even refinancing expenses.

**F. Installment Method of Reporting Boot Gain**

1. **Installment Method Reporting Generally**

Section 453 provides that an “installment sale” is a disposition of property where at least one payment is to be received in the taxable year following the year of disposition. Income from an installment sale is taken into account under the “installment method.” The installment method is defined as a method in which income recognized in any taxable year following a disposition equals x percent of the payments received, where x equals the gross profit over the total contract price.

2. **Installment Method Reporting in Like Kind Exchanges**

Section 453(f)(6)(C) provides that for purposes of the installment method, the receipt of qualifying like kind property will not be considered “payment.” The receipt of an installment obligation would constitute boot, the fair market value of which must be recognized to the extent of realized gain. Such recognized gain may be eligible for installment treatment if the taxpayer otherwise qualifies to use the installment method to report gain. Prop. Regs. § 1.453-1(f) provide for the timing of gain upon receipt of an installment obligation received in a like kind exchange. The Regulations generally allocate basis in the transferred property entirely to like kind property received in the exchange. The result is that less basis is allocated to the installment obligation. This is disadvantageous, since a greater portion of each payment received under the installment obligation will be subject to current tax.

   a. **Illustration**

Taxpayer exchanges property with a basis of $500,000 and a fair market value of $1 million for like kind property worth $750,000 and an installment obligation of $250,000. Under the Proposed Regulations, the entire $500,000 basis would be allocated to the like kind replacement property. No basis would be allocated to the installment obligation. Consequently, all principal payments on the note would be taxed as gain to the taxpayer. Had the $500,000 basis instead been permitted to be allocated to the installment obligation and the replacement property in proportion to their fair market values, the note would have attracted a basis of $125,000 (i.e., $500,000/4). In that case, 50 percent of each payment would have been a return of basis, and only 50 percent would have been subject to tax. The remainder of the realized gain would have been deferred until the replacement property were later sold.

**VII. Treatment of Liabilities**
A. Relief From Liabilities Treated as Cash Received

If another party to an exchange assumes liabilities associated with the relinquished property, the debt relief is treated as money received by the taxpayer, and is taxed as boot.\textsuperscript{14} Section 1031(d); Regs. § 1031(b)-1(c); \textit{Allen v. Com’r}, 10 T.C. 413 (1948). However, if the taxpayer also assumes liabilities associated with the replacement property, the two liabilities – those assumed by the taxpayer and those of which the taxpayer is relieved – are permitted to be netted. Regs. §1031(d)-2, Examples 1 and 2. Additional boot arises only when the taxpayer is relieved of more liabilities than he assumes in the exchange. In addition, cash and other nonqualifying property\textsuperscript{15} paid by the taxpayer is treated as a liability assumed by the taxpayer, and accordingly may be netted against liabilities associated with the relinquished property which are assumed by the other party. For example, if the taxpayer is relieved of a mortgage of 10\textdollar{} dollars, but also pays 10\textdollar{} dollars to the other party, the taxpayer will have no taxable boot. PLR 9853028 stated that a purchase money mortgage given by the taxpayer to acquire the replacement property may be netted against liabilities associated with relinquished property of which the taxpayer is relieved in the exchange.

1. Rationale for Permitting Cash Paid to be Netted

Assume the taxpayer is relieved of 10\textdollar{} dollars of liabilities but assumes only 5\textdollar{} dollars of liabilities in the exchange and is thus required to pay 5\textdollar{} dollars in cash. Although the taxpayer has net debt relief of 5\textdollar{} dollars, the Regulations permit the cash paid to offset the net debt relief. The rationale for allowing this tax treatment is that had the taxpayer reduced the liabilities associated with the relinquished property by 5\textdollar{} dollars prior to the exchange, the properties exchanged would be subject to identical mortgages, and no boot gain would result. Since the economics of the two situations are virtually identical – in both cases the taxpayer pays 5\textdollar{} dollars and ends up with property having a mortgage of 5\textdollar{} dollars – the taxpayer should not be required to report boot gain in one situation but not the other.

2. Determination of Whether Taxpayer’s Liabilities Assumed

Whether another party has assumed a liability of the taxpayer is determined under Section 357(d), which provides that, in general, a recourse liability is treated as having been assumed if the transferee has agreed to, and is expected to, satisfy such liability. The amount of a nonrecourse liability treated as having been assumed by the amount of the liability which an owner of assets not transferred to the transferee and also subject to such liability has agreed with the transferee to, and is

\textsuperscript{14} This boot, as distinguished from cash boot, is sometimes referred to as “mortgage boot.”

\textsuperscript{15} Cash as well as the fair market value of other property given may be netted against liabilities assumed. Regs. § 1.1031(d)(2) Example 2. Note that the absence of a distinction between cash and other property parallels Section 1031(b) which, for purposes of determining the amount of gain recognized in an exchange, makes no distinction between cash and “other property.”
expected to, satisfy.

3. **Cash Received Not Netted Against Liabilities Assumed**

Cash or other nonqualifying property received by the taxpayer in the exchange may not be netted against net liabilities assumed by the taxpayer in the exchange. Although the analysis justifying a “no boot” conclusion where the taxpayer pays cash could in theory be adopted in this situation, the IRS is unwilling to endorse this analysis. To illustrate: Taxpayer assumes liabilities of 10x dollars associated with the replacement property, is relieved of liabilities of 5x dollars in the exchange, and receives 5x dollars in cash. Even though the taxpayer has assumed 5x dollars of new net liabilities, he may not net the 5x dollars in cash received with the 5x dollars in new liabilities assumed – the taxpayer has taxable boot of 5x dollars. Regs. § 1.1031(d)-2; *Coleman v. Comr.*, 180 F.2d 758 (8th Cir. 1950).

**a. Possible Solutions?**

Since netting is not allowed in this situation, may the other party pay down the mortgage on the replacement property prior to the exchange, obviating the need for the taxpayer to receive an additional 5x dollars in cash? Or may the taxpayer increase the mortgage on the relinquished property by 5x dollars in advance of the exchange, thereby receiving mortgage proceeds rather than the cash from the other party? Presumably, the IRS could object unless a business purpose were present and the debt were “old and cold.” *See Garcia v. Com’r*, 80 T.C. 491 (1983), acq. 1984-1 C.B. 1, *infra*.

**B. Liability Netting Rules Summarized**

The netting rules may be summarized as follows:

<table>
<thead>
<tr>
<th>Net Liabilities Relieved vs. Liabilities Assumed</th>
<th>May Money or Other Property Given Offset</th>
<th>Liability Relief?</th>
<th>Boot Gain</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net Liabilities Relieved</td>
<td>None</td>
<td>No Money</td>
<td>Liabilities Received - Liabilities Assumed</td>
</tr>
<tr>
<td>Liabilities Relieved</td>
<td><strong>Given</strong></td>
<td>Yes</td>
<td>Liabilities Relieved - Liab. Assumed - Boot Given</td>
</tr>
<tr>
<td>Equal</td>
<td><strong>Received</strong></td>
<td>No</td>
<td>Liabilities Relieved - Liab. Assumed + Boot Rec’d</td>
</tr>
<tr>
<td>Liabilities Assumed</td>
<td>None</td>
<td>No Money</td>
<td>None</td>
</tr>
<tr>
<td><strong>Received</strong></td>
<td>Given</td>
<td>Yes</td>
<td>None</td>
</tr>
<tr>
<td>Net Liabilities Assumed</td>
<td><strong>Received</strong></td>
<td>No</td>
<td>Cash Received</td>
</tr>
<tr>
<td>Given</td>
<td>None</td>
<td>No Money</td>
<td>None</td>
</tr>
<tr>
<td><strong>Received</strong></td>
<td>Given</td>
<td>No</td>
<td>Cash Received</td>
</tr>
</tbody>
</table>

**Comment**

- Nothing to Net
- Netting Permitted
- Netting Not Permitted
- No netting required

**VIII. Consequences of Refinancing Before and After Exchanges**
A. Regulations Do Not Prohibit Pre-Exchange Financing

Pre-exchange financing may be arranged for the following reasons: (i) to avoid boot gain associated with debt relief; (ii) to extract cash tax-free from property to be exchanged; or (iii) to avoid the necessity of transferring cash in connection with an exchange. The Regulations contain no prohibition on pre-exchange financing. Furthermore, a straightforward reading of Regs. § 1.1031(b)-1(c) appears to treat a new loan obtained shortly before an exchange of relinquished property as bona fide debt if the relinquished property secures the debt. Nevertheless, the IRS may challenge pre-exchange financing unless the debt is “old and cold.”

B. Hypothetical Illustration of Pre-Exchange Financing

If the relinquished and replacement properties are of equal value, but the replacement property is subject to a larger mortgage, the cash buyer will be required to include cash for the consideration to be equal. Yet, that cash will cause boot gain to the taxpayer. Suppose instead the taxpayer mortgages the relinquished property in advance of the exchange to “even out” that mortgages? Since loan proceeds are not taxable, boot would appear to be avoided. The IRS might argue that the transaction lacks substance, since the taxpayer’s economic position is no different than it would have been had the cash buyer had simply paid cash boot.

1. Fredericks v. Com’r

Fredericks v. Com’r, T.C. Memo 1994-27 posed the scenario described above. The replacement property was more heavily mortgaged than the relinquished property. Rather than receive cash boot, the taxpayer mortgaged the relinquished property. Fredericks approved of the refinancing since it was (i) independent of the exchange; (ii) not conditioned on closing; (iii) dependent on creditworthiness of the taxpayer, rather than the cash buyer; and (iv) made sufficiently in advance (i.e., “old and cold”) of any contemplated exchange. If these requirements are not met, the IRS may argue that the mortgage was, in substance, obtained by the cash buyer and is taxable boot. See also, Behrens v. Com’r, T.C. Memo 1985-195. Ideally, the taxpayer’s reasons for refinancing should be unrelated to the exchange, and should be motivated, at least in part, by independent business purpose. Would partner discord or estate planning be such a purpose?

C. Pre-Exchange Financing With Replacement Property Less Risky

In the situation described above, the taxpayer mortgages the relinquished property and

16 The IRS proposed amending Regs. §1.1031(b)-1(c) to provide that consideration received in the form of debt relief may not be offset by consideration given in the form of an assumption of liabilities if liabilities were incurred in anticipation of an exchange. However, protests from practitioners resulted in the IRS abandoning the attempt.
receives cash to even out the mortgages. Refinancing relinquished property obviates the need for the taxpayer to receive cash boot. Pre-exchange refinancing by the seller of the replacement property may also be desirable where relinquished property is more heavily mortgaged than the replacement property. In this situation, if the mortgages are not evened out, the taxpayer will have to pay cash. In *Garcia v. Com'r*, 80 T.C. 491 (1983), acq. 1984-1 C.B. 1, to avoid having to pay cash, the taxpayer prevailed on the seller to increase the mortgage on the replacement property. *Garcia* prevailed and the IRS acquiesced. The *Garcia* type of pre-exchange financing appears to pose less tax risk than the type of financing accomplished in *Fredericks*, the critical difference being that while the taxpayer in *Garcia* received no cash, the taxpayer in *Fredericks* received a cash from a new mortgage on property that was soon to be relinquished.

1. **“Evening-Up” May Require Independent Business Purpose**

In PLR 8248039, the “evening-up” of mortgages prior to an exchange was permitted. In PLR 8434015, two loans were proposed to “even up” the mortgages. One loan was from a bank. The second was from owners of the replacement property, and was secured by the relinquished property. Citing the “tax-motivated refinancing of the property immediately prior to the exchange,” the IRS ruled that both loans constituted taxable boot. The refinancing in *Garcia* was distinguished on the basis of its having had “independent economic significance.” Thus, it appears that if the debt becomes taxpayer’s liability for more than the time needed to close on subsequent parts of the exchange, there is a greater likelihood that the loan will be respected for tax purposes, and there will be no IRS objection to the routine application of the boot-netting rules.

2. **Wittig v. Com'r.**

In *Wittig v. Comr.*, T.C. Memo, 1995-461, the replacement property was encumbered with a new mortgage prior the exchange. The taxpayer retained the loan proceeds. Although the Tax Court initially held that the taxpayer did not “assume or take subject to” a mortgage, as the Regulations require, it subsequently withdrew its decision as a part of a settlement that permitted the netting.

3. **PLR 9853028**

PLR 9853028 stated that a new mortgage placed on the replacement property could be netted against an existing mortgage on the relinquished property. The taxpayer’s immediate satisfaction of the new mortgage encumbering the replacement properties was inconsequential.

D. **Post-Exchange Financing Less Risky**

In contrast to pre-exchange financing – where the taxpayer is generally relieved of any new mortgage placed on the relinquished property following the exchange – in post-exchange financing,
the taxpayer will remain liable on any new mortgage taken out on the replacement property. Accordingly, such financing would likely attract less IRS scrutiny. Furthermore, there appears to be no judicial or legislative authority that would preclude a taxpayer from encumbering replacement property immediately after an exchange. However, the replacement property should be held for a period of time – no matter how brief – before encumbering the replacement property with a new mortgage; i.e., the “millisecond rule.” To avoid the step transaction doctrine, post-exchange financing should also be separated from replacement property financing, if at all possible. A different lender should be used for post-exchange financing.

1. **Step Transaction Doctrine**

The step transaction doctrine, which emphasizes substance over form, may be invoked by the IRS to collapse a multi-step transaction into a single transaction for tax purposes. The doctrine limits the taxpayer’s ability to arrange a series of business transactions to obtain a tax result that would unavailable if only a single transaction were used. The Supreme Court, in *Court Holding Company v. Com’r*, observed:

> To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress. 45-1 USTC ¶9215, 324 U.S. 331, 65 S.Ct. 707 (1945).

2. **Precautions to Observe When Closing Title**

When closing title where post-exchange financing is involved, the following additional precautions should be observed:

a. No new financing proceeds should be taken at the closing of the replacement property. Any refinancing with respect to the replacement property should be done separately and later, and should not appear on the replacement property closing statement; and

b. If additional construction draws will be made following the acquisition of the replacement property, only the advance made by the construction lender, and not the amount of the later draws, should be reflected on the closing statement.

IX. **Interest Tracing Rules**

Proper planning will help preserve the deduction for interest paid on refinanced indebtedness in connection with a Section 1031 exchange.
A. Interest Expense on Refinanced Indebtedness

The deductibility of interest on refinanced indebtedness depends on the use to which the borrowed funds are placed. In general, interest expense on a debt is allocated in the same manner as the debt to which the interest expense relates is allocated. Debt is allocated by tracing disbursements of the debt proceeds to specific expenditures. Temp. Regs. § 1.163-8T(a)(3). Property used to secure the debt is immaterial. Temp. Regs. § 1.163-8T(c)(1); § 1.163-8T(a)(3).

1. Allocation of Expenditures

Expenditures are allocated into one of six categories: (i) passive activities; (ii) former passive activities; (iii) investment; (iv) personal; (v) portfolio; and (vi) trade or business. Temp. Regs. § 1.163-8T(a)(4)(i)(A)-(E). Thus, the investment of refinancing proceeds in tax exempt bonds would result in a denial of the interest deduction. Likewise, personal use of refinancing proceeds will result in a complete denial of the interest deduction. The deduction for investment interest is limited to “net investment income.” Section 163(d)(1). Investment interest does not include interest taken into account under the passive activity loss rules. Section 163(d)(3)(A),(B). Proceeds of refinanced indebtedness used in an active business are subject to no limitations on deductibility. Section 163(a).

2. Allocation Period

Debt is allocated to an expenditure for the period beginning on the date the proceeds of the debt are used and ending on the earlier of (i) the date the debt is repaid; or (ii) the date the debt is reallocated. Temp. Regs. § 1.163-8T(c)(2).

3. Allocation of Debt Where Proceeds Not Disbursed to Taxpayer

If a lender disburses debt proceeds to a person other than the taxpayer, the debt is treated as if the taxpayer had used an amount of the debt proceeds equal to such disbursement to make an expenditure for such property. Temp. Regs. § 1.163-8T(c)(3)(ii).

4. Debt Assumptions Not Involving Cash Disbursements

If a taxpayer assumes a debt or takes property subject to a debt, and no debt proceeds are disbursed to the taxpayer, the debt is treated as if the taxpayer used an amount of the debt proceeds equal to the balance of the debt outstanding at such time to make an expenditure for such property. Temp. Regs. § 1.163-8T(c)(3)(ii).

5. Deposits Into Taxpayer’s Account

A deposit into the taxpayer’s account of debt proceeds, whether made by the taxpayer or by the lender, is treated as an investment expenditure, and amounts held
in the account are treated as property held for investment. Temp. Regs. § 1.163-8T(c)(4)(i). When funds in the account are disbursed for another type of expenditure, they are reallocated to that type of expenditure on the date the change in use occurs. Temp. Regs. § 1.163-8T(j)(1)(i).

a. Illustration

Taxpayer borrows $10,000 and places it into an account. The deposit is treated as an investment expenditure, and the interest accruing is treated as investment interest. If the funds are later used to make a personal expenditure, that interest would be personal interest.

6. Fifteen-Day Rule For Expenditures

Debt proceeds are generally considered expended from an account on a first-in, first-out basis, ignoring any unborrowed funds. Temp. Regs. § 1.163-8T(c)(4)(ii). However, a special rule allows the taxpayer to treat any expenditure made from an account within fifteen days after debt proceeds are deposited into such account as made from such proceeds to the extent thereof, notwithstanding the general rule. Temp. Regs. § 1.163-8T(c)(4)(iii)(B).

7. Treatment of Debt Proceeds Used to Pay Interest

If debt proceeds are used to pay interest, such debt is allocated in the same manner as the debt with respect to which the interest accrued. Temp. Regs. § 1.163-8T(c)(6)(ii). For debt allocated to more than one type of expenditure, the repayment of a portion of a debt will result in the repayment being applied first to personal expenditures.

X. Depreciation and Recapture Issues

Section 1245 or Section 1250 depreciation recapture can affect depreciable property held for more than one year and disposed of at a gain by reclassifying that gain as ordinary income.

A. Section 1245 Property Defined
Section 1245 property is any depreciable property consisting of either tangible personal property or intangible amortizable personal property described within Section 1245(a)(3)(B) through (F). Section 1245 property employs “accelerated” or “front-end loaded” methods of depreciation, such as 200 percent or 150 percent declining balance. Whether property constitutes Section 1245 property for depreciation purposes is a federal tax determination. Local law classification of property as real property or personal property – though important for purposes of Section 1031 – has little relevance for purpose of determining whether property is Section 1245 property or Section 1250 property.

B. **Section 1250 Property Defined**

Section 1250 property, defined by exclusion, consists depreciable real property, other than Section 1245 property. Commercial and residential real property both constitute Section 1250 property. Commercial property is depreciable over 39 years using the straight-line method, while residential real estate is depreciable on the straight-line method as well, but over 27.5 years.17

C. **Hospital Corporation of America**

*Hospital Corporation of America*, 109 T.C. 21 (1997) held that tangible personal property includes many items permanently affixed to a building. The decision, to which the IRS subsequently acquiesced, made viable the use of cost analysis studies to allocate building costs to structural components and other tangible property. The result of reclassification of Section 1250 property is the birth, for depreciation purposes, of Section 1245 property. By reclassifying Section 1250 real property as Section 1245 personal property, shorter cost recovery periods can be used. A successful cost segregation study would convert Section 1250 property to Section 1245 property with depreciation periods of five or seven years, using the double-declining balance method in Section 168(c) and (e)(1).18 The tax benefits accruing from a cost segregation study must be weighed against the cost of the study.

1. **Cost Segregation Study**

The IRS Cost Segregation Audit Techniques Guide states that a cost segregation study should be prepared by a person with knowledge of both the construction process and the tax law involving property classifications for depreciation purposes. In general, a study by a construction engineer is more reliable than one conducted by a person with no engineering or construction background.

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17 Section 50 provides for the recapture of the investment tax credit if property for which the investment tax credit was claimed is disposed of prior to the end of the recapture period. No exception is provided in the statute for Section 1031. Therefore, if property eligible for the investment tax credit is transferred in a like kind exchange, recapture will result.

18 Most personal property associated with real estate has a seven year recovery period. However, certain personal property used in rental real estate (*e.g.*, appliances, carpeting and furniture) has a five year recovery period. Ann. 99-82, 1992-2 CB 244.
Cost segregation professionals must verify the accuracy of blueprints and specifications, and take measurements to calculate the cost of assets and then to segregate them. The average cost segregation study may identify 25 percent to 30 percent of a property’s basis that is eligible for faster depreciation.

2. **Illustration**

Taxpayer plans to exchange land and a building in Brooklyn that he has owned for seven years. The property has a fair market value of $3 million and an adjusted basis of $1 million. As Section 1250 property, it has been depreciated using the straight-line method over 39 years. Replacement property, consisting of land and an office building in Manhattan is acquired for $3 million, 80 percent of the value of which is allocated to the building. The basis of the replacement building is therefore $800,000. The basis of the land is $200,000. A cost segregation study determines that 25 percent of the value of the office building is personal property qualifying for a 7-year recovery period using the 200 percent declining balance method of depreciation. The cost segregation study has increased the total first year depreciation deductions from $20,513 (i.e., $800,000/39) to $71,385 [(2/7) x $200,000].

3. **May IRS Challenge Decision Not to Reclassify?**

The IRS could argue that not all of property acquired in an exchange qualifies as like kind replacement real property, since some of the relinquished property might have earlier been reclassified as Section 1245 property, but was not. However, as a policy matter, this appears unlikely. Still, there appears to be no theoretical reason why the IRS could not argue that reclassification is not strictly elective. Therefore, a taxpayer who selectively reclassifies property, “cherry picking” those which yield the most depreciation deductions, while ignoring properties whose reclassification would produce fewer depreciation deductions, could conceivably the arouse IRS interest.

4. **Cost Segregation Best When Trading Up**

The basis of replacement property reflects the basis of relinquished property. If relinquished property has been heavily depreciated and little basis remains (or had a low basis to begin with) an otherwise successful cost segregation study of the replacement property would yield little tax benefit. However, if new funds have been invested or borrowed to exchange into more valuable property, the basis of the replacement property will reflect that investment, and a cost segregation study might yield tangible tax benefits.

D. **Effect of Reclassification on Like Kind Requirement**

1. **Reclassified Property May Not Be of Like Kind**
Some Section 1245 property, such as a barn, which constitutes a “single purpose agricultural structure” under Section 1245(a)(3)(D), would clearly be of like kind to real property. Section 1031 largely defers to local law in determining whether property is real or personal. However, local law may be unclear or ambiguous as to what constitutes real property. For example, state law may characterize permanently affixed machinery as real property for transfer tax purposes, but as personal property for UCC purposes. Therefore, some property may be classified as Section 1245 property for purposes of depreciation, since that is a federal tax determination, while at the same time be classified as real property for purposes of Section 1031, since that determination is predominantly one of local law.

2. **Dual Characterization Benefits Real Estate Owners**

If Section 1250 property has been reclassified as Section 1245 property for purposes of depreciation but still is real property under local law, the taxpayer will enjoy the best of both worlds: faster depreciation and qualification as real property for future exchange purposes. However, suppose reclassification results in Section 1245 property that is personal property under local law. If that property is later exchanged for either (i) real property or (ii) personal property that is not of like class,\(^a\) boot gain will result. Generally, if replacement property does not have the same “mix” of real and personal property for purposes of Section 1031 – or even the same “mix” of “like class” personal property, the resulting inability to completely satisfy the “like kind” exchange requirement will result in boot, and perhaps also depreciation recapture.

a. **Like Kind Exchange With No Boot**

As noted above, if Section 1245 property is classified as real property under local law, and is exchanged for property that is real property under local law, no boot will result. However, since Section 1245 trumps Section 1031, the taxpayer is not out of the woods, because the operative provisions of Section 1245, relating to depreciation recapture, might still apply. Depreciation recapture can occur in a boot-free like kind exchange if more Section 1245 property is relinquished in the exchange than is received.

b. **Like Kind Exchange With Boot**

\(^a\) Section 1031 grants vast preference to real property. Much stricter like kind exchange definitions apply to personal property, which must be of like kind or “like class” as defined in Regs. § 1.1031(a)-2. If Section 1245 property is classified as personal property, rather than real property, for purposes of Section 1031, the property exchanged must be of like kind or “like class.” Otherwise, boot will result.
If some or all of the relinquished property does not constitute real property under local law, it will not be of like kind to replacement property consisting entirely of real property under local law. Boot gain may also result if the Section 1245 property relinquished is not of “like class” to the Section 1245 property received in the exchange. In these situations, although the exchange may proceed, boot gain will result. As in the case where no boot is present, depreciation recapture may also result if more Section 1245 property is relinquished than is received in the exchange.

3. **Section 1245 Depreciation Recapture**

As noted above, whether or not boot gain is present, Section 1245 ordinary income depreciation recapture may occur in an exchange, if more Section 1245 property is relinquished than is received. Depreciation recapture would most often occur when accelerated recovery periods have been used to compute depreciation.

a. **Extent of Depreciation Recapture**

The amount of Section 1245 depreciation recapture depends on the extent to which depreciation taken exceeds straight line depreciation. However, in a Section 1031 exchange, Section 1245(b)(4) provides that total depreciation recapture cannot exceed the amount of gain recognized without regard to Section 1245 plus the fair market value of non-Section 1245 property acquired in the exchange. Therefore, Section 1245 recapture cannot exceed the sum of (i) boot gain attributable to the like kind exchange and (ii) the extent to which Section 1245 property relinquished in the exchange exceeds Section 1245 received in the exchange. Section 1245(b)(4)(B).

b. **Recapture Cannot Exceed Realized Gain**

Ordinary income recapture cannot exceed gain realized in the exchange. Section 1245(a)(1)(B).

c. **Class Life of Acquired Property**

The Regulations under Section 1245 require only that the replacement property be Section 1245 property to avoid recapture. Thus, no depreciation recapture will result if Section 1245 property with a class life of 7 years is replaced with Section 1245 property with a class life of 10 years. However, the boot analysis under Section 1031 is different. Boot will result if the Section 1245
property exchanged and received are not of like kind or like class, a
local law determination. In this respect, the recapture rules of
Section 1245 are more lenient than the boot rules of Section 1031.

E. Minimizing Section 1245 Property Relinquished

As noted, the extent of depreciation recapture may depend on the value of Section 1245
property relinquished versus the value of Section 1245 property received in the exchange. If more
Section 1245 property is relinquished than is received, ordinary income depreciation recapture may
result. Anticipating efforts to undervalue Section 1245 property relinquished than is received, ordinary income depreciation recapture may
result. Anticipating efforts to undervalue Section 1245 property relinquished, Regs. § 1.1245-
1(a)(5) requires the total amount realized on the disposition to be allocated between Section 1245
property and non-Section 1245 property in proportion to their respective fair market values. If the
buyer and seller have adverse interests, an arm’s length agreement will establish the allocation. In
the absence of an agreement, the allocation is based on a facts and circumstances approach.

F. Section 1250 Recapture Issues Rare

Although Section 1250 recapture can also occur in an exchange, the Tax Reform Act of 1986
generally required that both residential and commercial real property be depreciated on a straight
line basis. Therefore, Section 1250 recapture should no longer be an issue in most exchanges, even
if the exchange involves property that had previously been reclassified for depreciation purposes.
If property subject to Section 1250 depreciation recapture is disposed of in an exchange for
replacement property that is also Section 1250 property, the potential ordinary income recapture
rolls over into the replacement property and is deferred until a taxable sale of the replacement
property. Section 1031(d)(4)(D); Regs. § 1.1250-3(d)(5).

1. Unrecaptured Section 1250 Gain

Property subject to unrecaptured Section 1250 gain is taxed at 25 percent
when sold. Section 1(h)(7). Unrecaptured Section 1250 gain applies to all
depreciation taken on real property, whether straight line or otherwise, except for
Section 1250 “excess” depreciation that is subject to ordinary income recapture.

a. Fate of Unrecaptured Gain Following Exchange

What happens to unrecaptured Section 1250 gain following
a like kind exchange? The Code does not address the issue.
Presumably, unrecaptured Section 1250 gain would be treated in the
same manner as Section 1250 excess depreciation, so that the
delayed unrecaptured Section 1250 gain would roll over into the
replacement property.

G. Allocation of Basis Upon Reclassification

Basis must be allocated to reclassified replacement property following a Section 1031
exchange, since reclassified replacement property will consist of both Section 1245 and Section 1250 property. The aggregate basis of the reclassified replacement property equals the basis of the relinquished property, with adjustments as provided for in Section 1031(d). Regs. § 1.1245-5(a)(2) requires that basis first be allocated to non-Section 1245 property to the extent of its fair market value, with the residue being allocated to Section 1245 property. The effect of this forced allocation will be to produce longer depreciation periods.

XI. Related Party Transactions

A. In General

Section 1031(f) was enacted as part of the Revenue Reconciliation Act of 1989 to eliminate revenue losses associated with “basis shifting” in some related party exchanges. Basis shifting occurs when related persons exchange high basis property for low basis property, with the high basis property being sold thereafter by one of the related persons. Basis shifting allows the parties to retain desired property but shift tax attributes. S. Rep. No. 56, 101st Cong., 1st Sess. 151 (1989). Section 1031(f)(1) largely precludes the nonrecognition treatment of gain or loss when a taxpayer exchanges like-kind property with a related person, when either party disposes of the exchanged property within two years. The rules suffer from the defect that many related party transactions involve no tax avoidance. The rules can even work to deny exchange treatment where a tax-deferred exchange could easily have been accomplished, but a related party was involved merely to facilitate the exchange.

1. Related Person Described

A “related person” is any person bearing a relationship to the taxpayer described in Sections 267(b)\textsuperscript{20} or 707(b)(1).

a. Section 267(b)

Section 267(b) includes (i) family members (spouses, siblings, ancestors, and lineal descendants); (ii) an individual and a corporation more than 50 percent of the value of the outstanding stock of which is owned, directly or indirectly, by or for such individual; (iii) two corporations which are members of the same controlled group; (iv) certain grantors, fiduciaries and beneficiaries of trusts; and (v) a corporation and a partnership if the same person owns more than 50 percent of the value of the outstanding stock of the corporation and more than 50 percent of the capital or the profits interest in the partnership.

b. Section 707(b)(1)

\textsuperscript{20} The attribution rules of Section 267(c) apparently do not apply to related party exchanges.
Section 707(b)(1) includes (i) a partnership and a person owning, directly or indirectly, more than 50 percent of the capital or profits interest in such partnership; and (ii) two partnerships in which the same person owns, directly or indirectly, more than 50 percent of the capital interest or profits interest.

2. **Operation of Statute**

Section 1031(f)(1) establishes a 2-year holding period for property given or received in an exchange involving related persons. The holding period begins on the date of the last transfer constituting part of the related party exchange. (In a deferred exchange, the date of the last transfer may be up to 180 days after the transfer of the relinquished property.) If *either* related party “disposes” of property acquired in the exchange within two years of the initial exchange date, gain or loss deferred on the initial exchange will be recognized *as of the date of the subsequent disposition*. Section 1031(g) suspends the running of the 2-year period during any time when an exchange party’s risk of loss is substantially diminished through certain contractual arrangements, such as a put option. See *Coastal Terminals, Inc. v. U.S.*, 320 F.2d 333 (4th Cir. 1963); Revenue Ruling 61-119, 1961-1 C.B. 395.

3. **Illustration**

Son owns unimproved Florida swampland with a basis of 20x dollars and a fair market value of 10x dollars. Father owns a fully depreciated Manhattan building with a basis of 0 dollars and a fair market value of 50x dollars. Father and son exchange the properties in an exchange qualifying for father. Prior to Section 1031(f), son could have sold the Manhattan property immediately after acquiring it and recognize a loss. Father’s gain would be deferred. The effect of the presale exchange had the effect of deferring recognition of father’s potential gain of 50x dollars, and accelerating recognition of son’s 10x dollar loss. Section 1031(f) requires father to recognize deferred gain realized in the initial exchange if within 2 years of the initial exchange either of the following occurs: (i) son disposes of the Manhattan property or (ii) father disposes of the Florida property. For example, if either father or son disposes of property acquired in the exchange after one year, father will at that time be required to report all of the initial deferred gain. However, in that case father would still benefit from one year of tax deferral.

a. **Variation of Illustration**

Prior to the enactment of the related party rules, in the above illustration, father could have repurchased the Manhattan property from son at fair market value and obtained a new depreciable basis. However, that strategy might have been challenged under the step
transaction doctrine.

4. “Disposition” Defined

The term “disposition” is broad in scope and encompasses many transfers of property whether they be by sale, gift, contributions to an entity, or the granting of easements. The legislative history indicates that nonrecognition transfers involving carryover basis, such as those described in Sections 351, 721 or 1031 itself, do not constitute dispositions for the purposes of Section 1031(f)(1)(c)(ii). The granting of a lease should not be a disposition, provided the lease is a “true” lease. However, the term disposition does include an indirect disposition of property, such as that which occurs in connection with the transfer of corporate stock or a partnership interest. S. Rep. No. 56, 101st Cong., 1st Sess. 151-152 (1989).

a. Grantor Trusts

Transfers to a grantor trust do not constitute a “disposition” within the meaning of Section 1031(f)(1)(c)(ii). PLR 9116009. However the transfer by a grantor trust to a third party or the termination of grantor trust status might be a disposition.

5. “Excepted” Dispositions

Under Section 1031(f)(2)(A)-(C), certain transactions, which would otherwise constitute “dispositions” for purposes of Section 1031(f)(1)(c)(ii), are excepted from the application of the related party rules. These exceptions are limited to dispositions which occur by reason of (i) the death of either related party; (ii) a compulsory or involuntary conversion under Section 1033 (if the exchange occurred before the threat or imminence of such conversion); or (iii) under Section 1031(f)(2)(C), a transaction with respect to which neither the exchange nor the disposition “had as one of its principal purposes the avoidance of federal income tax.” (The Conference Committee Report states that the exception is intended to apply to situations (i) that do not involve the shifting of basis between related taxpayers and to those (ii) that involve the partitioning of property between siblings which results in each taxpayer owning the entire interest in a single property.)

a. Illustration of Section 1031(f)(2)(C) Exception

Taxpayer enters into a safe harbor deferred exchange agreement with a qualified intermediary and transfers property to a cash buyer through the QI. A related party, who has no interest in pursuing a like kind exchange, acquires replacement property for cash. The taxpayer identifies that property as replacement property, and the second leg of the
exchange proceeds through the QI. The related party merely facilitated the exchange. No tax avoidance purpose is present. Arguably, the related party rules should be inapplicable here. However, after *Teruya Brothers Ltd. v. Com'r*, discussed below, this hypothesis may be suspect, at least in the Ninth Circuit.

6. **Section 1031(f)(4) “Catch All”**

Section 1031(f)(4) provides that like kind exchange treatment will not be accorded to any exchange that is a part of a transaction, or series of transactions, structured to avoid the purposes of Section 1031(f).

7. **Time For Testing Relationship**

The relationship is tested at the time of the exchange. If parties become “related” after the exchange, the related party rules presumably will not apply. Conversely, if the parties are related at the start of the exchange, the transaction will presumably be subject to the related party rules even if the parties are no longer related at the time of a disposition to which the subsection applies. For example, assume the taxpayer were to exchange property with an S corporation owned by his brother. A year later brother sells all of his stock in the S corporation. Shortly thereafter, the S corporation sells the property originally acquired from the taxpayer. The sale by the S corporation would result in gain to the taxpayer, even though the taxpayer and the S corporation were no longer related at the time of the sale. With the same facts, the S corporation would also recognize gain if the taxpayer sold the property he originally acquired within the two-year period.

8. **Two Year Rule is Safe Harbor**

Field Service Advisory (FSA) 200137003 stated that the related party rules have no application after the 2-year period has elapsed, regardless of taxpayer motive. Therefore, waiting 2 years following an exchange may immunize the exchange from the application of the related party rules. However, taxpayers would be well advised not to structure any tax transaction solely on the basis of a Field Service Advisory, which has little precedential value.

9. **Depreciation Recapture**

Related party dispositions within 2 years may also trigger depreciation recapture. Section 1239 recharacterizes as ordinary income gain recognized on sales or exchanges between persons related under Sections 1239(a) or 707(b)(1) and (2). Since no gain is ordinarily recognized initially in a related party exchange, no ordinary income recapture would occur at the initial exchange if no boot is present.
If boot is present, ordinary income recapture could occur, but not by reason of the related party rules, but rather by the application of Section 1239 itself. If recharacterization under Section 1239 would otherwise have occurred at the time of the initial like-kind exchange but for the fact that no boot is present, the IRS takes the position is that a related party disposition within the proscribed period will trigger ordinary income recapture at the time of the later related party disposition. See PLR 8350084, 8646036, and Revenue Ruling 72-151.

10. “Insurance” Against Lapsing of Replacement Period

May the taxpayer identify and acquire replacement property from a related party if other identified properties owned by unrelated parties cannot be acquired within the 180-day replacement period? Provided the taxpayer intended to close on the other properties, it seems as if the “no tax avoidance” exception of Section 1231(f)(2)(C) would be met in this circumstance.

B. Does Section 1031(f) Address Only Two-Party Swaps?

Sections 1031(f) and (g) seem to address only direct two-party swaps between related persons. The Regs do not state whether three-party exchanges (involving the taxpayer, an unrelated party, and a related party) or four-party exchanges (involving the taxpayer, an unrelated party, a qualified intermediary or accommodator, and a related party) are within the scope of the statute. Could a taxpayer transfer property to a related party but acquire replacement property from an unrelated party or from a QI without triggering Section 1031(f)? In its rulings, the IRS seems to take the view that if a related person is involved in the exchange in any capacity (e.g., a buyer, seller or prior owner of any of the properties involved in the exchange) the Section 1031(f)(4) tax-avoidance “catch all” may apply.

1. More Cash in Related Party Group?

One test used in determining whether the Section 1031(f)(4) “catch all” applies is to determine whether the related persons, as a group, have more cash after the related party transaction than before. If cash “leaves” the group, there is less chance that a tax avoidance motive is present. Conversely, if cash “enters” the group, a tax avoidance purpose is more likely.

2. Technical Advice Memorandum 9748006

In TAM 9748006, the taxpayer transferred property to an unrelated party, and acquired his mother’s property through an unrelated party as replacement property. The exchange violated Section 1031(f)(4), since the economic result of the series of transactions was identical to a direct exchange between the taxpayer and his mother, followed by her sale of the relinquished property. The TAM stated that “a qualified intermediary is not entitled to better treatment than the related party referred to in the House Budget Committee Report.”
3. **Field Service Advisory (FSA) 199931002**

FSA 199931022 extended the reach of Section 1031(f) to transactions involving qualified intermediaries. The taxpayer engaged a QI to facilitate an exchange in which the taxpayer transferred property to an unrelated party and directed the QI to use the proceeds to acquire replacement property from a related party. The IRS advised that the taxpayer’s sale of the replacement property within two years of the exchange violated Section 1031(f)(4), since the replacement property had been transferred from a related party. TAM 9748006 and FSA 199931002 address exchanges involving replacement property originating from a related party. However, the statute may also apply where a related party acquires the taxpayer’s relinquished property through a third party.

4. **Revenue Ruling 2002-83**

In Rev. Rul. 2002-83, the taxpayer’s property was sold to an unrelated party through a QI. The QI acquired the related party’s property for cash and transferred it to the taxpayer to complete the exchange. By using a QI, the taxpayer and the related party avoided a direct exchange within Section 1031(f)(4). The ruling stated that the engagement of a QI was part of a transaction structured to avoid Section 1031(f). The taxpayer was not entitled to nonrecognition treatment since, as part of the transaction, a related party received cash or other non-like kind property.

5. **Teruya Brothers Ltd. v Com’r**

*Teruya Brothers Ltd. v. Com’r*, 124 T.C. No. 4 (2005) illustrates the danger of using a QI where the related party rules could apply. *Teruya*, in a series of transactions, transferred several properties to a QI, who sold them to unrelated parties. The QI used the proceeds to purchase replacement properties from a corporation related to the taxpayer. The Tax Court held that the transaction constituted a taxable sale rather than a deferred exchange, since it had been structured to avoid the purpose of Section 1031(f). Although the corporation recognized more gain on its sale than the taxpayer deferred, it had large net operating losses (NOL) which offset its gain. The court rejected the argument that the non-tax-avoidance exception of Section 1031(f)(2)(C) applied.

a. **Ninth Circuit Uphold Tax Court**

The Ninth Circuit in late 2010 upheld the Tax Court’s decision in *Teruya*. The Court of Appeals found that Teruya had “decreased their investment in real property by approximately $13.4 million, and increased their cash position by the same amount. Therefore, Teruya had effectively “cashed out” of its investment. Noting that Teruya could have achieved
the same property disposition through “far simpler means,” the court observed that the transactions “took their peculiar structure for no purpose except to avoid § 1031(f). The presence of the QI, which ensured that Teruya was “technically exchanging properties with the qualified intermediary . . . served no purpose besides rendering simple – but tax disadvantageous – transactions more complex in order to avoid § 1031(f)’s restrictions. The exception found in § 1031(f)(2)(C) was inapplicable since “the improper avoidance of federal income tax was one of the principal purposes behind these exchanges.” (No. 05-73779; 9/8/09).

6. **Ocumulgee Fields v. Com’r (T.C. No. 6 (2009)).**

In this case, the taxpayer transferred appreciated property to a qualified intermediary under an exchange agreement, whereupon the QI sold the same property to an unrelated party and used the sale proceeds to purchase like kind property from a related person that was transferred back to the taxpayer to complete the exchange. The IRS assessed a deficiency, arguing that the exchange was part of a series of transactions designed to avoid § 1031(f) and that the taxpayer had not established the “lack of tax avoidance” exception under § 1031(f)(2)(C). Citing Teruya Bros., Ltd., the Tax Court agreed with the IRS, noting that the immediate tax consequences resulting from the exchange would have reduced taxable gain by $1.8 million, and would have resulted in a substitution of a 15% tax rate for a 34% tax rate. After Ocumulgee, and the Ninth Circuit decision in Teruya, it may be difficult to find a more likely than not basis to proceed with an exchange involving a related party in instances where the related party already owned the replacement property. The Tax Court came close to holding that basis shifting virtually precludes, as a matter of law, the absence of a principal purpose of tax avoidance.

7. **PLR 200616005**

In PLR 200616005, Trust and S Corp. were related parties. Trust desired as replacement property a building owned by S Corp. S Corp. intended to complete its
own Section 1031 exchange. A qualified intermediary was used to accomplish the exchanges. The related party rules would not apply, provided the Trust and the S Corp. each held their respective replacement properties for at least two years. Section 1031(f) did not apply since neither party had “cashed out” of its investment.

8. **PLR 200706001**

In PLR 200706001, three siblings and a trust owned three tracts of timberland. One sibling wished to continue the timber investment, but the others wished to cash out. To achieve this result, one of the siblings exchanged her undivided 25 percent fractional interest in parcel 1 for a fee simple interest in parcel 3. Like kind treatment was accorded pursuant to Rev. Rul. 73-476, which provides that an exchange of an undivided interest in real estate for 100 percent ownership of one or more parcels qualifies for exchange treatment. Although Section 1031(f) appeared to apply – the taxpayer exchanged her interest with a related party, and the related party then sold various parcels – the IRS concluded that since the transaction did not involve basis-shifting, the related party rules did not apply.

9. **PLR 200712013**

In PLR 200712013, a related party wished to acquire the taxpayer’s property (“Blackacre”). However, the related party owned no property which the taxpayer wished to acquire. A plan was devised whereby the taxpayer in step one would acquire replacement property (“Whiteacre”) in an exchange last “reverse exchange”. Accordingly, the taxpayer provided funds to the Exchange Accommodator Titleholder (EAT), which acquired Whiteacre. At this point, the EAT held title to Whiteacre, which would eventually be transferred to the taxpayer. In step two, the taxpayer and the related party entered into a contract for the sale of Blackacre for cash. In step three, the taxpayer assigned all rights in this contract to a qualified intermediary (QI). In step four, the QI transferred title in Blackacre to the related party for cash. In step five, the QI transferred the cash to the EAT, which then transferred title in Whiteacre to the taxpayer and extinguished the taxpayer’s debt, thus completing the reverse exchange. In the ruling request, the related party stated that it intended to dispose of Blackacre within two years. Ruling favorably, the IRS stated that Section 1031(f)(4) would not apply to this transaction, since the transfer of Blackacre to a related party was not part of a “transaction or series of transactions structured to avoid the purposes of Section 1031(f)(1).” The related party did not own any property prior to the exchange; therefore no shifting of basis occurred. Therefore, the sale by the related party of Blackacre within two years would not trigger gain. **An important aspect of this ruling was that the QI was not viewed as an agent of the taxpayer for purposes of applying Section 1031(f)(1).**

10. **PLR 200919027**
In PLR 20091027, the taxpayer, the taxpayer’s sibling, and a trust were tenants in common of real property. The trustees of the trust wished to sell their interest in the real property. To increase the marketability of the interests sold, the three owners agreed to exchange each of their undivided 1/3 interest in the property for 100 percent fee simple interests in the same property. The proposed division would split the property into three parcels of equal value. The taxpayer sought a ruling regarding the applicability of IRC § 1031(f) to the proposed exchange. The ruling held that while the taxpayer and the taxpayer’s sibling were related, neither intended to sell their property within two years. Further, the taxpayer was not related to the trust within the meaning of IRC § 1031(f)(3); (i.e., the trust did not bear a relationship to the taxpayer described in IRC §267(b) or 707(b)(1). Accordingly, the ruling stated that with respect to the taxpayer and the trust, there was no exchange between related persons for purposes of IRC §1031(f).

C. Reporting Related Party Exchanges

Form 8824 (“Like Kind Exchanges”) requires the taxpayer to state whether the replacement property was acquired directly or indirectly from a related party. The instructions state that indirect related party exchanges include (i) an exchange made with a related party through an intermediary (such as a qualified intermediary or an exchange accommodation titleholder) or (ii) an exchange made by a disregarded entity (i.e., a single member LLC) if the taxpayer or a related party owns that entity. Form 8824 must be filed for two years following the taxable year of a related party exchange.

XII. Multi-Party Exchanges

A. Rationale

If like kind exchanges were limited to simultaneous exchanges involving two parties, few exchanges would transpire, since both parties – whether or not they both sought exchange treatment – would have to desire the other’s property. This is not likely to be often the case. Responding favorably to taxpayer creativity in finessing the problem of simultaneity, courts in the 1970’s developed the doctrine that replacement property could originate from a third person involved in the exchange. Often, three or four parties were involved. Multiparty deferred exchanges received the imprimatur of the Ninth Circuit in Starker v. U.S., 602 F.2d 1341 (9th Cir., 1979), which recognized a deferred exchange occurring over five years. While the IRS recognized simultaneous multi-party exchanges in Revenue Ruling 77-297, it never acquiesced to Starker’s view that exchanges were not required to be simultaneous. The IRS objection to Starker was mooted by the enactment of Section 1031(a)(3) in the Tax Reform Act of 1984, which expressly recognized deferred exchanges.

B. Dynamics of Multi-Party Exchange
A three-party exchange would typically involve the taxpayer, and two other persons, Y and Z. Y would acquire the taxpayer’s property, and Z would own the replacement property. To accommodate the taxpayer, Y would purchase Z’s property and then exchange it for the taxpayer’s property. If Y were unwilling to acquire Z’s property to complete the exchange, an intermediary might be used. In that case, M, for a fee, would acquire Z’s property. At closing, M would simultaneously (i) acquire Z’s property for cash; (ii) transfer that property to the taxpayer in exchange for the taxpayer’s property; and (iii) transfer the taxpayer’s property to Y for cash. Since the transactions would be simultaneous, cash from Y’s purchase of the relinquished property could be used by M to purchase the replacement property from Z.

1. **Taxpayer Must Avoid “Substantial Implementation” Test**

   In *Estate of Bowers*, 94 T.C. 582 (1990), the taxpayer owned an oil and gas lease that he agreed to sell for $2 million. Three months later, taxpayer agreed to purchase a farm for $1.1 million. The taxpayer then attempted to structure the transaction as an exchange, by inducing the purchaser of the oil and gas lease to first acquire the farm, which would then be exchanged for the oil and gas lease. Invoking the “substantial implementation” test, the Tax Court determined that Bowers had sold the oil and gas lease and had purchased the farm prior to the contemplated exchange. The taxpayer’s reporting of income attributable to the farm on a tax return filed before the exchange belied his tax position. Bowers demonstrates the importance of planning for exchange treatment before implementing the sale of relinquished property or the acquisition of replacement property.

C. **Problems with Multi-Party Exchanges**

1. **Problem of Intent**

   The IRS position had long been that a “sale” followed by a reinvestment of the proceeds could not qualify for exchange treatment, despite the taxpayer’s intention to effectuate an exchange. However, *Garcia*, 80 T.C. 491 (1983), *acq.*, 1984-1 C.B.1 held that the taxpayer’s intent is important, especially if the form of the transaction is consistent with an exchange. However, the court added that neither intent nor result alone is determinative in deciding whether an exchange has occurred. A year after Garcia was decided, the IRS acquiesced. 1984-1 C.B.1., PLR 8434015.

2. **Problem of Simultaneity**

   Garcia approved the use of escrows, which had become a practical necessity in effectuating multi-party exchanges. Since multiparty exchanges can now be structured to come within a safe harbor enumerated in the deferred exchange Regulations, why should simultaneity any longer even be an issue? The
answer is that while simultaneous or deferred exchanges are both permitted under the safe harbor Regulations, exchanges cannot always be structured to come within a safe harbor. Moreover, even if safe harbor qualification is possible, the taxpayer may not wish to incur the additional expense of engaging the services of a qualified intermediary. Therefore, a deferred multiparty non-safe-harbor exchange may still be contemplated in certain situations.

3. **Problem of Constructive Receipt**

As noted above, an “accommodator” may purchase desired replacement property, transfer it to the taxpayer in exchange for relinquished property, and then transfer the relinquished property to a cash buyer, completing the exchange. The risk of employing this strategy is that the IRS may view the accommodator as the taxpayer’s agent. *See Coupe v. Comr.,* 52 T.C. 394 (1969), *acq.,* 1970-2 C.B. xix. If so, the taxpayer would be in constructive receipt of the exchange funds, taking the transaction out of Section 1031. However, *Garcia* demonstrates that courts are inclined to minimize the agency issue if the taxpayer intends to effectuate an exchange.

a. **Escrow Agents**

Regs. 1.1031(k)-1(f)(2) provides that actual or constructive receipt of money by an agent of the taxpayer constitutes actual or constructive receipt of the funds by the taxpayer. However, *Reed v. Com’r,* 723 F.2d 138, (1st Cir. 1983) held that an escrow agent is not the taxpayer’s agent for tax purposes provided the escrow agent represents the interests of both the taxpayer-seller and the other party to the escrow agreement. *See Hillyer v. Comr.,* T.C. Memo 1996-214. At closing, the party from whom the replacement property is acquired must receive payment directly from the escrow agent. The taxpayer may receive money or other nonqualifying property when closing on the replacement property. However, this property will constitute taxable boot to the extent of realized gain.

(1) **Taxpayer’s Attorney as Escrow Agent**

If the escrow agent is the taxpayer’s attorney, the attorney could be deemed the taxpayer’s agent for income tax purposes. However, by reason of the attorney’s fiduciary obligations as escrowee, this is unlikely. Furthermore, it appears that some of the strict rules relating to escrowed funds have also been tempered somewhat to reflect administrative necessities involving real estate transactions. Apparently, the
taxpayer’s attorney may deposit the down payment for the relinquished property in an escrow account, and may pay certain closing costs (e.g., title fees) without jeopardizing qualification under Section 1031.

4. **Problem of Taxpayer’s Involvement in Transaction**

Will the taxpayer’s involvement in the acquisition of replacement property by taking part in the negotiations along with the intermediary impair the tax-deferred exchange? Revenue Ruling 77-297 states that the taxpayer can properly assist in locating and identifying replacement property. Will the taxpayer’s guarantee of an accommodator’s obligation to acquire replacement property result in a determination that the accommodator is the taxpayer’s agent for federal tax purposes? Will direct-deeding of replacement property to the taxpayer (rather than through the accommodator) imperil exchange treatment? *Brauer v. Com’r* 74 T.C. 1134 (1980) held that the failure of the accommodator to acquire legal title would not result in a denial of exchange treatment. The trend of the cases is that none of these actions will necessarily imperil an exchange, provided the taxpayer’s intent was to complete an exchange. However, the accommodator in a multi-party exchange must actually incur risks and obligations – no matter how insignificant and how brief – in connection with acquiring the replacement property. The Fifth Circuit, in *Swaim v. U.S.* 651 F.2d 1066 (5th Cir. 1981) held that mere intention to effectuate a tax-free exchange is insufficient.

D. **Use of QI Safe Harbors in Simultaneous Exchanges**

Issues of agency and constructive receipt can be avoided by utilizing the “qualified intermediary” safe harbor, discussed below. However, the QI safe harbor cannot be used in a three-party exchange, where the cash buyer acquires the replacement property and transfers that property to the taxpayer, since the deferred exchange regulations provide that the QI must acquire and transfer the relinquished property. In a three-party exchange, the cash buyer acquires and retains the relinquished property. This requirement of transfer appears to necessitate the use of a professional QI in a safe harbor deferred exchange.

XIII. **Deferred Exchanges Under the Regulations**

A. **Deferred Exchanges Sanctioned in Starker v. U.S.**

A deferred exchange may be a practical necessity if the cash buyer insists on closing before the taxpayer has identified replacement property. Recognizing the problem, *Starker v. U.S.*, 602 F2d 1341 (9th Cir. 1979) articulated the proposition that simultaneity is not a requirement in a like kind exchange: “[W]e hold that it is still of like kind with ownership for tax purposes when the taxpayer prefers property to cash before and throughout the executory period, and only like kind property is ultimately received.” Responding to the IRS refusal to acquiesce to *Starker*, evolving case law
which permitted nonsimultaneous exchanges was codified by the Tax Reform Act of 1984.

B. Statutory Basis for Deferred Exchanges: TRA 1984

As amended, Section 1031(a)(3)(A) provides that the taxpayer must

IDENTIF[Y] . . . PROPERTY TO BE RECEIVED IN THE EXCHANGE [WITHIN] 45 DAYS AFTER . . . THE TAXPAYER TRANSFERS THE PROPERTY RELINQUISHED IN THE EXCHANGE.

The Regulations refer to this as the “identification period.” Regs. § 1.1031(k)-1(b)(1)(i). The identification of the replacement property must be evidenced by a written document signed by the taxpayer and hand delivered, mailed, telecopied or otherwise sent before the end of the identification period to (i) the person obligated to transfer the replacement property to the taxpayer (i.e., the cash seller); or (ii) to all persons involved in the exchange (e.g., any parties to the exchange, including an intermediary, an escrow agent, and a title company). Regs § 1.1031(k)-1(c)(2). The 45-day period is jurisdictional: failure to identify replacement property within 45 days will preclude exchange treatment. Moreover, contrary to many other time limitation periods provided for in the Internal Revenue Code, the 45-day period is computed without regard to weekends and holidays.

1. When Does Identification Period Begin to Run?

The statute states the 45-day identification period begins upon the “transfer” of the relinquished property. Does the identification period therefore begin to run on the closing date? Or when the exchange funds are transferred if that date is not coincident? Can an argument be made that the identification period does not commence until the deed is actually recorded?

2. Multiple Transfers of Relinquished Property

Where multiple transfers of relinquished property occur, the 45-day identification period (as well as the 180-day exchange period) begin to run on the date of transfer of the first property. Treas. Reg. § 1.1031(k)-1(b)(2).

3. Backdating Identification Documents Constitutes Tax Fraud

Some taxpayers, unable to identify replacement property within 45 days, have attempted to backdate identification documents. This is a serious mistake. The taxpayer in Dobrich v. Com’r, 188 F.3d 512 (9th Cir. 1999) was found liable for civil fraud penalties for backdating identification documents. Dobrich also pled guilty in a companion criminal case to providing false documents to the IRS. If the 45-day identification period poses a problem, the taxpayer should consider delaying the sale of the relinquished property to the cash buyer. If the sale cannot
be delayed, the possibility should be explored of leasing the property to the cash buyer until suitable replacement property can be identified.

a. **Recognizing Losses**

It would appear that a taxpayer could deliberately structure an exchange to recognize a loss by deliberately failing to identify replacement property within the 45-day period.

4. **Description Must be Unambiguous**

Replacement property must be unambiguously described in the written document or agreement. Real property is generally unambiguously described by a street address or distinguishable name (e.g., the Empire State Building). Personal property must contain a particular description of the property. For example, a truck generally is unambiguously described by a specific make, model and year. Regs. § 1.1031(k)-1(b)(1).

a. **Acquisition Without Identification Permitted**

Acquisition of replacement property before the end of the identification period will be deemed to satisfy all applicable identification requirements (the “actual purchase rule”). Regs. § 1.1031(k)-1(c)(4)(ii)(A). However, even if closing is almost certain to occur within the 45-day identification period, formally identifying replacement property insures against not closing within the 45-day identification period. Identifying back-up replacement property insures against not closing on the intended replacement property within the 180-day exchange period.

5. **Three Rules for Identifying Replacement Properties**

a. **“3 Property Rule”**

Up to three replacement properties may be identified without regard to fair market value. Regs. § 1.1031(k)-1(c)(4)(i)(A).

b. **“200 Percent Rule”**

Any number of properties may be identified provided their aggregate fair market value does not exceed 200 percent of the aggregate fair market value of all relinquished properties as of the date the relinquished properties were transferred. Regs. § 1.1031(k)-1(c)(4)(i)(B).
c. “95 Percent Rule”

If more than the permitted number of replacement properties have been identified before the end of the identification period, the taxpayer will be treated as having identified no replacement property. However, a proper identification will be deemed to have been made with respect to any replacement property (i) received before the end of the identification period and (ii) identified before the end of the identification period and received before the end of the exchange period, provided the taxpayer receives before the end of the exchange period identified property the fair market value of which is at least 95 percent of the aggregate fair market value of all identified properties. Regs. § 1.1031(k)-1(b)(3)(ii)(A)-(B).

(1) Risks and Benefits of 95 Percent Rule

In situations where the taxpayer is “trading up” and wishes to acquire replacement property whose fair market value is far in excess of the relinquished property, this rule is useful. While under the 200 percent rule, the taxpayer may acquire property whose fair market value is twice that of the relinquished property, under the 95 percent rule, there is no upper limit to the new investment. While there is also no upper limit to the value of the replacement property using the 3 property rule, substantial diversification may not be possible using that rule. Although the 95 percent rule therefore possesses distinct advantages, there is a substantial risk: If the taxpayer does not satisfy the 95 percent rule, then the safe harbor is unavailable. This could result in the disastrous tax result of exchange treatment being lost with respect to all replacement properties. If the 95 percent rule is to be used, the taxpayer must be confident that he will ultimately be successful in closing on 95 percent of all identified properties. There is little room for error.

d. Failing All Three Identification Rules Does Not Necessarily Mean No Exchange

In TAM 200602034, the taxpayer identified
numerous properties whose fair market value well exceeded 200% of the fair market value of the relinquished property, so neither the 3-property rule nor the 200% rule could be satisfied. In addition, since the value of the replacement properties ultimately acquired was less than 95% of the value of all identified replacement properties, the taxpayer also failed the 95% rule. This meant that only those properties that satisfied the “actual purchase rule,” i.e., those properties actually acquired within 45-days of the date of sale of the relinquished property, were deemed to have satisfied the identification requirement.

6. Revocation of Identification

An identification may be revoked before the end of the identification period provided such revocation is contained in a written document signed by the taxpayer and delivered to the person to whom the identification was sent. An identification made in a written exchange agreement may be revoked only by an amendment to the agreement. Regs. § 1.1031(k)-1(c)(6). Oral revocations are invalid. Regs. § 1.1031(k)-1(c)(7), Example 7, (ii).

7. “Incidental Property Exception”

Regs. § 1.1031(k)-1(c)(5)(i) provides that minor items of personal property need not be separately identified in a deferred exchange. However, this exception in no way affects the important statutory mandate of Section 1031(a)(1) that only like kind property be exchanged. Therefore, if even a small amount of personal property is transferred or received, the like kind and like class rules apply to determine whether boot is present and if so, to what extent. It may therefore be advantageous for the parties to agree in the contract of sale that any personal property transferred in connection with the real property has negligible value.

8. Identification Period Where Multiple Parcels

If multiple parcels are relinquished in the exchange, the 45-day period begins to run upon the closing of the first relinquished property. The last replacement property must close within 180 days from that date. If compliance with this rule is problematic, it may be possible to fragment the exchange into multiple deferred exchanges.

9. Multiple vs. Alternative Identifications
If exchange proceeds remain, the determination of whether the taxpayer has made “multiple” or “alternative” identifications may be important. If the identification was alternative, compliance with one of the three identification rules may be less difficult. Whether an identification is alternative may depend upon the taxpayer’s intent.

C. Replacement Property Must Be Acquired Within 180 Days

Section 1031(a)(3)(B) provides that replacement property must be acquired **on the earlier of**

180 DAYS AFTER THE . . TAXPAYER TRANSFERS
THE PROPERTY RELINQUISHED IN THE EXCHANGE,
OR THE DUE DATE [INCLUDING EXTENSIONS] FOR
THE TRANSFEROR’S RETURN FOR THE TAXABLE
YEAR IN WHICH THE TRANSFER OF THE
RELINQUISHED PROPERTY OCCURS.

Thus, if A relinquishes property on July 1st, 2006, he must identify replacement property by August 14th, 2006, and acquire all replacement property on or before January 1st, 2007, which date is the earlier of (i) January 1st, 2007 (180 days after transferring the relinquished property) and July 15th, 2007, (the due date of the taxpayer’s return, including extensions). This period is termed the “exchange period.” Regs. § 1.1031(k)-1(b)(1)(ii). The exchange period is also jurisdictional: failure to acquire all replacement property within the prescribed time limit will result in a taxable sale, rather than a like kind exchange. The exchange period, like the identification period, is calculated without regard to weekends and holidays.

1. **Due Date of Tax Return Determined Without Regard to Automatic Extensions**

The Ninth Circuit, in *Christensen v. Com’r*, T.C. Memo 1996-254, *aff’d in unpub. opin.*, 142 F.3d 442 (9th Cir. 1998) held that the phrase “due date (determined with regard to extension)” in Section 1031(a)(3)(B)(i) contemplates an extension that is actually requested. If the taxpayer fails to request an extension (even if one were automatically available) the due date of the taxpayer’s return without regard to extension would be the operative date for purposes of Section 1031(a)(3)(B). (However, if the due date for the taxpayer’s return without regard to extensions occurs after the 180-day period following the exchange, the point would be moot, since the taxpayer would in that case be required to complete the exchange within the 180-day period.)

2. **Replacement Property Must be Substantially Same**

Replacement property actually received must be substantially the same as the replacement property earlier identified. While the construction of a fence on
previously identified property does not alter the “basic nature or character of real
property,” and is considered as the receipt of property that is substantially the same
as that identified, the acquisition of a barn and the land on which the barn rests,
without the acquisition also of the previously identified two acres of land adjoining
the barn, will result in the taxpayer being considered not to have received
substantially the same property that was previously identified. Regs. § 1.1031(k)‐1(d), Examples 2 and 3.

a. Replacement Property to be Produced

Replacement property that is not in existence or that is
being produced at the time the property is identified will be
considered as properly identified provided the description contains
as much detail concerning the construction of the improvements as
is possible at the time the identification is made. Moreover, the
replacement property to be produced will be considered
substantially the same as identified property if variations due to
usual or typical production occur. However, if substantial changes
are made in the property to be produced, it will not be considered
substantially the same as the identified property. Regs. §
1.1031(k)‐1(e).

D. Actual or Constructive Receipt Negates Like‐Kind Exchange

If the taxpayer actually or constructively receives money or other property in the full
amount of the consideration for the relinquished property before the taxpayer actually receives the
like kind replacement property, the transaction will constitute a sale and not a deferred exchange.
If the taxpayer actually or constructively receives money or other property as part of the
consideration for the relinquished property prior to receiving the like kind replacement property, the
taxpayer will recognize gain with respect to the nonqualifying property received (to the extent of
realized gain). Regs. § 1.1031(k)‐1(f)(2).

1. Definitions of Actual or Constructive Receipt

For purposes of Section 1031, the determination of whether the taxpayer
is in actual or constructive receipt of money or other property is made under
general rules concerning actual and constructive receipt without regard to the
taxpayer’s method of accounting. The taxpayer is in actual receipt when he
actually receives money or other property or receives the economic benefit thereof.
Constructive receipt occurs when money or other property is credited to the
taxpayer’s account, set apart for the taxpayer, or otherwise made available so that
the taxpayer may draw upon it. Section 446; Regs. § 1.446‐1(c). However, the
taxpayer is not in constructive receipt of money or other property if the taxpayer’s
control over its receipt is subject to substantial limitations. Regs. § 1.1031(k)‐1(f)(1),(2).
E. Safe Harbors Avoid Problem of Constructive Receipt

On April 25, 1991, final Regulations for deferred exchanges were promulgated. Regs. § 1.1031(k)-1(g). Presumably, the vast majority of deferred exchanges (and all involving qualified intermediaries) must now comply with one of the four safe harbors provided for in the regulations. Sensibly, the regulations also permit simultaneous exchanges to be structured under the deferred exchange regulations. While simultaneous exchanges can also be structured outside of the deferred exchange regulations, compliance with the safe harbor avoids difficult issues of constructive receipt and agency. It may therefore be beneficial to structure even simultaneous exchanges whenever possible under the deferred exchange regulations “qualified intermediary” safe harbor. That safe harbor is the only deferred exchange safe harbor made applicable to simultaneous exchanges. Regs. § 1.1031(b)-2.

1. Security or Guarantee Arrangements

The first safe harbor insulates the taxpayer from being in actual or constructive receipt of exchange proceeds where the obligation of the cash buyer to provide funds for replacement property is secured by a mortgage or letter of credit. Specifically, the safe harbor provides that whether the taxpayer is in actual or constructive receipt of money or other property before receipt of replacement property will be made without regard to the fact that the obligation of the taxpayer’s transferee (i.e., the cash buyer) is or may be secured by (i) a mortgage; (ii) a standby letter of credit (provided the taxpayer may not draw on the letter of credit except upon default by the transferee); or (iii) a guarantee of a third party. This safe harbor would typically be used where no qualified intermediary is present to secure the obligation of the cash buyer to finance the replacement property. Regs. § 1.1031(k)-1(g)(2). Compliance with this safe harbor eliminates concerns that the taxpayer is in constructive receipt of the secured obligations. However, compliance with this safe harbor does not dispel concerns about agency.

2. Qualified Escrow or Trust Accounts

The second safe harbor is similar to the first, except that instead of applying to situations involving a guarantee or letter of credit, this safe harbor addresses those situations in which the exchange funds themselves are segregated in an escrow account. The second safe harbor thus provides that the determination of whether the taxpayer is in actual or constructive receipt of money or other property before the receipt of replacement property will be made without regard to the fact that obligation of the taxpayer’s transferee to transfer the replacement property is or may be secured by cash or a cash equivalent, provided the funds are held in a “qualified escrow account” or a “qualified trust account.” Regs. § 1.1031(k)-1(g)(3). Note that compliance with this safe harbor also dispels concerns about constructive receipt, but also does not dispel concerns about agency. Only the qualified intermediary safe harbor, discussed below, addresses both of these issues.
a. **Qualified Escrow or Trust Account Defined**

A qualified escrow (or trust) account is an escrow (or trust) account in which (i) the escrow holder (or trustee) is not the taxpayer or a “disqualified person,” and (ii) the escrow agreement limits the taxpayer’s right to receive, pledge, borrow, or otherwise obtain the benefits of the cash or cash equivalent held in the escrow account. Regs. § 1.1031(k)-1(g)(3)(ii).

(1) **Disqualified Person**

(a) **Agent of Taxpayer**

The agent of the taxpayer is a disqualified person. For this purpose, a person who has acted as the taxpayer’s employee, attorney, accountant, investment banker or broker, or real estate agent or broker within the 2-year period ending on the date of the transfer of the first of the relinquished properties is treated as an agent of the taxpayer. However, services rendered in furtherance of the like kind exchange itself, or routine financial, title insurance, escrow or trust services are not taken into account.

(b) **Attribution**

A person who bears a relationship to the taxpayer described in Section 267(b) or Section 707(b), (determined by substituting in each section “10 percent” for “50 percent” each place it appears) is a disqualified person.

(c) **Attribution of Agent**

A person described in either Section 267(b) or Section 707(b), (determined by substituting in each
section “10 percent” for “50 percent” each place it appears) who bears a relationship to a person described in (a) above, is a disqualified person.

i) **T.D. 8982**

Following promulgation of Treas. Decision 8982 in 2002, the IRS issued final regulations 107175-00 which permits banks and affiliated subsidiaries to act as qualified intermediaries even if the bank or bank affiliate is related to an investment banking or brokerage firm that provided investment services to the taxpayer within 2 years of the date of the exchange.

3. **Qualified Intermediaries**

The qualified intermediary safe harbor is the most useful of the four safe harbors, as it addresses both agency and constructive receipt concern. This safe harbor provides that (i) a “qualified intermediary” is not considered an agent of the taxpayer for tax purposes, and (ii) the taxpayer is not considered to be in constructive receipt of exchange funds held by the qualified intermediary. For the QI safe harbor to apply, the exchange agreement must expressly limit the taxpayer’s right to receive, pledge, borrow or otherwise obtain the benefits of money or other property held by the QI, until after the exchange period, or until the occurrence, after the identification period, of certain contingencies beyond the control of the taxpayer. Regs. § 1.1031(k)-1(g)(4).

a. **Distinguish Tax Agency from Legal Agency**
The QI safe harbor bestows upon the transaction the important presumption that the taxpayer is not in constructive receipt of funds held by the QI—regardless of whether the taxpayer would otherwise be in constructive receipt under general principles of tax law. In addition, the QI is not considered the taxpayer’s agent for tax purposes. However, the QI may act as the taxpayer’s agent for other legal purposes, and the exchange agreement may so provide. For example, if the taxpayer is concerned about the possible bankruptcy of the QI, expressly stating that the QI is the taxpayer’s agent for legal purposes would reduce the taxpayer’s exposure. So too, the QI may be concerned with taking legal title to property burdened with possible claims or environmental liabilities. By stating that the QI is acting merely as the taxpayer’s agent, those concerns of the QI might be adequately addressed.

b. Three-Party Exchange and QI Safe Harbor

In a three-party exchange, the cash buyer accommodates the taxpayer by acquiring the replacement property and then exchanging it for the property held by the taxpayer. Since the QI safe harbor imposes the requirement that the QI both acquire and transfer the relinquished property and the replacement property, it appears that this safe harbor cannot be used in a three-party exchange since, in such an exchange, the cash buyer acquires the taxpayer’s property, but does not thereafter transfer it. Therefore, most safe harbor QI transactions would require four parties: i.e., the taxpayer, the QI, a cash buyer and a cash seller.

c. QI Safe Harbor Permitted in Simultaneous Exchange

The final Regulations permit the safe harbor for qualified intermediaries (but only that safe harbor) in simultaneous, as well as deferred, exchanges. Regs. § 1.1031-(k)-1(g)(4)(v).

d. Definition of Qualified Intermediary

A qualified intermediary is a person who (i) is not the taxpayer or a “disqualified person” and who (ii) enters into a written agreement (“exchange agreement”) with the taxpayer to (a) acquire the relinquished property from the taxpayer; (b) transfer the relinquished property to a cash buyer; (c) acquire replacement property from a cash seller; and (d) transfer replacement property to the taxpayer. Regs. § 1.1031(k)-1(g)(iii). A number of companies, often affiliated with banks, act as qualified
intermediaries. If an affiliate of a bank is used as a QI, it may be prudent to require the parent to guarantee the QI’s obligations under the exchange agreement. Qualified intermediaries generally charge a fee (e.g., $1,000), but earn most of their profit on exchange funds invested during the identification and exchange periods. Although the QI might pay the taxpayer three percent interest on exchange funds held during the identification and exchange periods, the QI might earn four percent during those periods, providing the QI with a profit of one percent on the exchange funds held during the identification and exchange periods.

(1) Acquisition and Transfer by QI

A QI is treated as acquiring and transferring property (i) if the QI itself acquires and transfers legal title; or (ii) if the QI (either on its own behalf or as the agent of any party to the transaction) enters into an agreement with a person other than the taxpayer for the transfer of the relinquished property to that person and, pursuant to that agreement, the relinquished property is transferred to that person; or (iii) if the QI (either on its own behalf or as the agent of any party to the transaction) enters into an agreement with the owner of the replacement property for the transfer of that property and, pursuant to that agreement, the replacement property is transferred to the taxpayer. These rules permit the owner of the replacement property to directly deed replacement property to the taxpayer at the closing. Regs. § 1.1031(k)-1(g)(4)(iv)(A),(B)&(C). This may avoid additional complexity as well as additional transfer tax liability and recording fees.

(2) Assignment to QI

A QI is treated as entering into an agreement if the rights of a party to the agreement are assigned to the QI and all parties to the agreement are notified in writing of the assignment on or before the date of the relevant property transfer. Therefore, if a taxpayer enters into an agreement for the transfer of the relinquished property and thereafter assigns its rights thereunder to a QI and
all parties to the agreement are notified in writing of the assignment on or before the date the relinquished property is transferred, the QI is treated as entering into that agreement. If the relinquished property is transferred pursuant to that agreement, the QI is treated as having acquired and transferred the relinquished property. Regs. § 1.1031(k)-1(g)(v).

e. Protecting Relinquished Property Proceeds

(1) Hold Funds in Separate Escrow Account

Regs. § 1.1031(k)-1(g)(3) permit the QI to deposit cash proceeds from the sale of the relinquished property into a separate trust or escrow account, which could protect funds against claims of the QI’s creditors. The exchange documents must still limit the exchanging party’s right to receive, pledge, borrow or otherwise receive the benefits of the relinquished property sale proceeds prior to the expiration of the exchange period. Regs. § 1.1031(k)-1(g)(6). These are referred to as the “G-6 Limitations.” One disadvantage to this approach is that if sales proceeds are significant, a better rate of return might be possible if the QI were not required to segregate the funds in a separate escrow account until the closing on the replacement property. Even though the QI will typically pay only a nominal interest rate on exchange funds being held, funds deposited into an escrow account may earn even less interest.

(2) Use Letter of Credit or Guarantee

The obligation of the QI may be secured by a standby letter of credit or a third party guarantee. The standby letter of credit must be nonnegotiable and must provide for the payment of proceeds to the escrow to purchase the replacement property, rather than to the taxpayer.

f. Permissible Disbursements by QI

Regs. § 1.1031(k)-1(g)(7) enumerates items which may be
paid by the QI without impairing the QI safe harbor, and which will be disregarded in determining whether the taxpayer’s right to receive money or other property has been expressly limited, as required. If an expense qualifies under the Regulations, not only will the QI safe harbor remain intact, but no boot will result.Regs. § 1.1031(k)-1(g)(7)(ii) provides that a QI may make disbursements for “[t]ransactional items that relate to the disposition of the relinquished property or to the acquisition of the replacement property and appear under local standards in the typical closing statement as the responsibility of a buyer or seller (e.g., commissions, prorated taxes, recording or transfer taxes, and title company fees).” The Regulations do not include legal fees as a transactional item. Regs. § 1.1031(k)-1(g)(7)(i) provides that the QI may also pay to the seller items which a seller may receive “as a consequence of the disposition of the property and that are not included in the amount realized from the disposition of the property (e.g., prorated rents).”

**g. Reimbursement of Taxpayer**

If the taxpayer makes a deposit for replacement property, the QI may reimburse the taxpayer from exchange funds, but only after the replacement property has been acquired.

**h. ABA Position on QI Disbursements**

The ABA Tax Section Report on Open Issues first notes that Revenue Ruling 72-456, and GCM 34895 recognize that transactional expenses typically incurred in connection with an exchange, and not deducted elsewhere on the taxpayer’s return, offset boot. The Report notes that these expenses correspond closely to the list of transactional items found in Regs. § 1.1031(k)-1(g)(7). The Report concludes that transactional selling expenses paid by a QI should be treated as transactional items under Regs. § 1.1031(k)-1(g)(7) which can be paid by the QI at any time during the exchange period without affecting any of the safe harbors under Regs. § 1.1031(k).

**i. Other Payments Made by QI**

Payments made by a QI not enumerated in Regs. § 1.1031(k)-1(g)(7) would presumably constitute boot. However, the question arises whether those payments would also destroy the safe harbor. Regs. § 1.1031(k)-1(j)(3), Example 4, concludes the taxpayer who has a right to demand up to $30,000 in cash is in
constructive receipt of $30,000, and recognizes gain to the extent of $30,000. However, Example 4 neither states nor implies that the exchange no longer qualifies under the safe harbor. Therefore, payment of an expense not enumerated in Regs. § 1.1031(k)-1(g)(7) to a person other than the taxpayer would result in boot, but would likely not destroy the safe harbor. However, any payment from the QI to the taxpayer during the exchange period would destroy the safe harbor.

4. **Tax Treatment of Exchange Funds Held by QI**

On July 7, 2008, the IRS issued final regulations under Section 468B(g) and 7872 regarding funds held by exchange facilitators in various safe harbors provided by Treas. Reg. § 1.1031(k)-1(g). The Regulations provide rules regarding the taxation of income earned on such escrow accounts, trusts, and other funds used in deferred like-kind exchanges. Under the final regulations, exchange funds are treated, as a general rule, as loaned by the taxpayer to an exchange facilitator, and the exchange facilitation then takes into account all items of income, deduction and credit. If, however, the escrow agreement, trust agreement, or exchange agreement provides that all earnings attributable to the exchange are payable to the taxpayer, the exchange funds are not treated as loaned from the taxpayer to the exchange facilitator, and the taxpayer then takes into account all items of income, deduction and credit. The final regulations apply to transfers of relinquished property made on or after October 8th, 2008.

a. **Imputed Interest on Deemed Loan**

Under Regs. § 1.468B, if the exchange agreement does not require the QI to pay to the taxpayer sufficient interest on the deemed loan, interest will be imputed under Section 7872. Sufficient interest is determined at a rate at least equal to the lower of the short-term AFR or the 13-week Treasury bill rate. The QI is first treated as paying interest to the taxpayer on earnings which the QI retains. The taxpayer is then treated as compensating the QI with an amount equal to the deemed interest payment received by the taxpayer.

b. **De Minimis Exception**

Exemption from Section 7872 if exchange funds do not exceed $2 million and the funds are held for six months or less.

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21 Section 7872 provides for the tax treatment of below-market loans.
c. **Exception: “All of the Income” to Taxpayer**

One exception provides that if all of the earnings attributable to exchange funds are paid to the taxpayer, exchange funds are not treated as loaned from the taxpayer to the QI. The all the earnings rule applies if (i) the QI holds all of the taxpayer’s exchange funds in a separately identified account; (ii) the earnings credited to the taxpayer’s exchange funds include all earnings on the separately identified account; and (iii) the credited earnings must be paid to the taxpayer (or be used to acquire replacement property.)

d. **Effect of Imputed Interest Rule**

The rule forces the taxpayer to capitalize as part of the cost of acquiring property (rather than deduct as a current expense) amounts paid to the QI. The applicable rate of interest on these transactions is the investment rate on a 182-day Treasury bill, determined at the time the imputed loan is made. This rate is published at www.publicdebt.treas.gov.

e. **Divergence of Tax Treatment**

The safe harbor deferred exchange rules provide that the taxpayer will not be in constructive receipt of exchange funds for purposes of Section 1031. However, under the Proposed Regulations, an interesting tax dichotomy emerges. Even though the taxpayer is not considered as receiving the exchange funds for purposes of Section 1031, the taxpayer is treated as receiving those funds for other income tax purposes.

f. **Disbursements Deemed Made by Taxpayer**

For purposes of determining whether earnings attributable to exchange funds are payable to the taxpayer, transactional expenses such as appraisals, title examinations, recording fees and transfer taxes are treated as first paid to the taxpayer and then paid by the taxpayer to the recipient. A fee paid to the QI qualifies as a transactional expense if (i) the amount of the fee is fixed on or before the date the relinquished property is transferred and (ii) the fee is payable regardless of whether earnings attributable to exchange funds are sufficient to cover the fee. This rule is intended to address the perceived problem of a qualified intermediary “fee” actually being an interest “surrogate.”
5. **Interest and Growth Factors**

The fourth safe harbor provides that the determination of whether the taxpayer is in actual or constructive receipt of money or other property before the receipt of replacement property is made without regard to the fact that the taxpayer is or may be entitled to receive any interest or growth factor with respect to the deferred exchange. Regs. § 1.1031(k)-1(g)(5).

6. **Traps for the Unwary**

a. **Escrow Agreement Must Contain Limitations**

The escrow agreement itself must expressly limit the taxpayer’s right to pledge, borrow or otherwise obtain the benefits of the cash held in the escrow account before the end of the exchange period. Regs. § 1.1031(k)-1(g)(2)(ii). It is not enough that the limitations exist in an ancillary document, or that they derive from local law.

(1) **Retained Rights of Taxpayer**

Regs. § 1.1031(k)-1(g)(5) provides several rules which address situations in which replacement property is not received by the end of the exchange period, or an unexpected contingency causes the exchange to go awry. First, despite the general rule that the taxpayer may not retain rights with respect to money being held by the QI, the exchange agreement may provide that the taxpayer may receive money at the end of the identification period if no replacement property has been identified by that time. Second, the taxpayer may retain the right to receive money held by the QI following the occurrence, after the identification period, of a material and substantial contingency that (i) relates to the deferred exchange; (ii) is provided for in writing; and (iii) is beyond the control of the taxpayer and any disqualified person.

b. **Boot Paid By QI Destroys Safe Harbor**

Money or other property paid to the taxpayer by another party to the exchange will constitute boot, but it will not destroy the safe harbor. However, the payment of money or other property
from the QI or from another safe harbor arrangement prior to the receipt of all replacement properties to which the taxpayer is entitled under the exchange agreement will destroy the safe harbor. Regs. § 1.1031(k)-1(g)(6).

7. **Installment Sale Reporting of Deferred Exchanges**

To benefit from Section 453 installment reporting, the taxpayer must avoid the receipt of “payment” in the taxable year of the disposition. Section 453 provides, in general, that the term “payment” does not include the receipt of evidences of indebtedness of the person acquiring the property. However, Temp. Regs. § 15A.453-1(b)(3)(i) provides that receipt of an evidence of indebtedness that is secured directly or indirectly by cash or a cash equivalent is treated as the receipt of payment. The Temporary Regulations also state that the term “payment” includes amounts actually or constructively received under an installment obligation. The IRS has suggested that the exchange funds described in the deferred exchange safe harbor Regulations could be considered as “payment” under Temp. Regs. § 15A.453-1(b)(3)(i). Fortunately, the final Regulations provide that the safe harbors themselves, rather than Temp. Regs. § 15A.453-1(b)(3)(i), apply in determining whether the taxpayer is in receipt of “payment” at the beginning of the exchange period. However, for this override rule to apply, the taxpayer must have a “bona fide intent” to enter into a deferred exchange at the beginning of the exchange period. Regs. § 1.1031(k)-1(k)(2)(iv) state that a taxpayer possesses a bona fide intent to engage in an exchange only if it reasonable to believe at the beginning of the exchange period that like kind replacement property will be acquired before the end of the exchange period. If the intent requirement is met, gain recognized from a deferred exchange structured under one or more of the safe harbors will qualify for installment method reporting (provided the other requirements of Sections 453 and 453A are met.)

a. **Illustration**

On November 1st, 2006, QI, pursuant to an exchange agreement with New York taxpayer (who has a bona fide intent to enter into a like kind exchange) transfers the Golden Gate Bridge to cash buyer for $100 billion. The QI holds the $100 billion in escrow, pending identification and ultimate closing on the replacement property by the taxpayer. The taxpayer’s adjusted basis in the bridge is $75 billion. The exchange agreement provides that taxpayer has no right to receive, pledge, borrow or otherwise obtain the benefits of the cash being held by QI until the earlier of the date the replacement property is delivered to the taxpayer or the end of the exchange period. On January 1st, 2007, QI transfers replacement property, the Throgs Neck Bridge, worth $50 billion, and $50 billion in cash to the taxpayer. The taxpayer
recognizes gain to the extent of $25 billion. However, the taxpayer is treated as having received payment on January 1st, 2007, rather than on November 1st, 2006. If the other requirements of Sections 453 and 453A are satisfied, the taxpayer may report the gain in 2007 under the installment method. **Note:** If the QI had failed to acquire replacement property by the end of the exchange period, and had distributed $50 billion in cash to the taxpayer on January 1st, 2007, Regs. § 1.1031(k)-1(j)(2)(iv) would still permit gain to be reported on the installment method, since the taxpayer had a bona fide intent at the beginning of the exchange period to effectuate a like kind exchange. **Note also:** Under its “clawback” rule, California will continue to track the deferred gain on the exchange involving the Golden Gate Bridge. If the taxpayer later disposes of Throgs Neck Bridge in a taxable sale, California will impose tax on the initial deferred exchange. This will result in the taxpayer paying both New York (7.7 percent) and California (9.3 percent) income tax, in addition to New York City (4.45 percent) and federal income tax (15 - 25 percent) on the later sale.

### 8. Inadvertent Opt-Out of From Installment Method

In PLR 200813019, the IRS permitted the taxpayer to correct an inadvertent opt-out of the installment method. The taxpayer had intended to engage in a like kind exchange, but failed to acquire replacement property within 180 days. The taxpayer’s accountant reported all of the income in year 1, even though the failed exchange qualified as an installment sale because the taxpayer had not been in actual or constructive receipt of some of the exchange proceeds until the year following that in which the relinquished property was sold. Treas. Reg. § 15.453-1(d)(4) provides that an election to opt-out of installment sale treatment is generally irrevocable, and that an election may be revoked only with the consent of the IRS. The IRS allowed the taxpayer to revoke the inadvertent opt-out, noting that the opt-out was the result of the accountant’s oversight, rather than hindsight by the taxpayer.

### 9. Structuring Down Payment

**a. Replacement Property Deposit**

**(1) Deposit Made by QI**

The taxpayer may request that the QI make an earnest money deposit on the replacement
property only after the replacement property purchase contract has been assigned to the QI. The purchase contract should expressly provide that if the contract is terminated for any reason, the earnest money will be returned to the QI and not to the taxpayer.

(2) Deposit Made by Taxpayer

The taxpayer may instruct the seller of the replacement property with an earnest money deposit. At closing, the seller may refund the earnest money deposit to the taxpayer provided the QI provides the seller with a replacement down payment check. Alternatively, the QI can reimburse the taxpayer, but only after the taxpayer has actually received the replacement property.

b. Relinquished Property Deposit

If the exchange agreement has already been assigned to the QI, any earnest money deposit should be made to the QI. However, if the taxpayer has already received the earnest money deposit prior to the assignment of the contract to the QI, the taxpayer’s attorney may refund the deposit to the purchaser at closing. The purchaser would then increase the amount of the total sales proceeds to reflect the refunded deposit.

10. Regulation of Qualified Intermediaries

Consolidation of qualified intermediaries has raised concerns regarding transfers of QI accounts during exchanges. There continues to be concern with respect to QI insolvencies in the wake of several well-publicized failures, e.g., LandAmerica, November 2008. The Federation of Exchange Accommodators (FEA) has asked the Federal Trade Commission (FTC) and the IRS to regulate Qualified Intermediaries. Both have declined. Nevada and California regulate Qualified Intermediaries. Under California’s law, the QI is required to use a qualified escrow or trust, or maintain a fidelity bond or post securities, cash or a letter of credit in the amount of $1 million. The QI must also have an errors and omissions insurance policy. Exchange facilitators must meet the prudent investor standard, and cannot commingle
exchange funds. A violation of the California law creates a civil cause of action.

F. Required Legal Documentation

1. Language for Relinquished Property Contracts

The following or similar language should appear in the contract of sale of the relinquished property:

The Purchaser understands that this transaction may, at the option of the Seller, constitute one part of a tax-deferred exchange as recognized under Section 1031 of the Internal Revenue Code. In that event, Purchaser agrees to execute any and all documents (subject to the reasonable approval of Purchaser’s counsel) as are necessary in connection therewith, at no cost, expense or liability to Purchaser, provided that the close of this transaction for the conveyance of Seller’s property shall not be continent upon such exchange.

2. Language for Replacement Property Contract

The following or similar language should appear in the purchase contract for the replacement property:

The Seller understands that this transaction is one part of a tax-deferred exchange as recognized under Section 1031 of the Internal Revenue Code. Seller agrees to execute such documents as may reasonably be required to qualify the transaction for treatment under that section. Seller further agrees: (i) that purchaser’s interests in this contract may be assigned to a qualified intermediary (the Intermediary) (ii) that Seller will deed the property as directed by the Intermediary; and (iii) that the Intermediary can terminate this contract by the payment of liquidated damages in an amount not to exceed the funds held by the Intermediary.

3. Exchange Agreement

a. Exchange Agreement Recitals

The exchange agreement entered into by the taxpayer and the QI will recite that the taxpayer (i) owns certain real property; (ii) has entered into an agreement with a purchaser to sell
relinquished property; (iii) desires to effectuate a Section 1031 exchange; and (iv) that the intermediary is willing and able to act as a “Qualified Intermediary” as defined in Regs. § 1.1031(k)-1(g)(4).

b. **Exchange Agreement Substantive Terms**

The exchange agreement will substantively provide that the taxpayer (i) has assigned rights in the contract to sell the relinquished property to the QI; (ii) will transfer the relinquished property to the QI in exchange for replacement property to be identified by the taxpayer; (iii) will have no right to receive cash paid by the purchaser to acquire the relinquished property; (iv) will receive credit from the QI for amounts received from the sale of the relinquished property (less fees and closing costs incurred by QI) for the purpose of acquiring the replacement property; (v) will receive interest on the exchange credit until acquisition of the replacement property; (vi) will identify and acquire replacement property within time limits imposed by Section 1031; and that in order to avoid additional transfer tax, the taxpayer (vii) will deed his property directly to the purchaser; and the seller of the replacement property (viii) will deed that property directly to the taxpayer.

4. **Assignment of Rights in Relinquished Property**

The taxpayer must (i) execute an assignment of rights in the contract for the sale of the relinquished property to the QI; and must (ii) furnish the buyer of the relinquished property and all parties to the exchange agreement with notice of assignment of the taxpayer’s rights in the relinquished property contract to the QI pursuant to Regs. § 1.1031(k)-1(g)(4)(v). Notice of the assignment can be given at or before the closing.

5. **Notice of Identification of Replacement Property**

On or before the end of the 45-day identification period, the taxpayer must, in accordance with Regs. § 1.1031(k)-1(b) and (c), identify one or more replacement properties to be acquired by the QI in exchange for the relinquished property. The replacement property must be identified in a written document signed by the taxpayer and mailed or faxed to the QI and all other persons involved in the exchange. (If the replacement property is acquired simultaneously with the transfer of the relinquished property, or is otherwise acquired prior to the end of the identification period, the replacement property will be deemed identified.)

6. **Assignment of Rights in Replacement Property**
The taxpayer must (i) execute an assignment of rights in the contract for the purchase of the replacement property to the QI; and must (ii) furnish the seller of the replacement property and all parties to the exchange agreement with notice of assignment of the taxpayer’s rights in that contract pursuant to Regs. § 1.1031(k)-1(g)4(v). Notice of the assignment can be given at or before the closing.

XIV. Reverse Exchanges

A. History of Reverse Exchanges

Although the deferred exchange regulations apply to simultaneous as well as deferred exchanges, they do not apply to reverse exchanges. See Preamble to final Regulations, 56 Red. Reg. 19933 (5/1/91). Reverse exchanges occur where the taxpayer acquires replacement property before transferring relinquished property. Perhaps because they are intuitively difficult to reconcile with the literal words of the statute, reverse exchanges were slow to gain juridical acceptance. An early case, Rutherford v. Com’r, TC Memo (1978) held that purchases followed by sales could not qualify under Section 1031. However, Bezdijian v. Com’r, 845 F.2d 217 (9th Cir. 1988) held that a good exchange occurred where the taxpayer received heifers in exchange for his promise to deliver calves in the future. Following Bezdijian, taxpayers began engaging in reverse exchanges in which either relinquished or replacement property was “parked” with an accommodator. Just as deferred exchanges were recognized by courts, so too, reverse exchanges soon received a judicial imprimatur. The acquisition of replacement property prior to the transfer of relinquished property – a situation apparently not contemplated when Section 1031 was enacted – is termed a “reverse exchange.” However, many of the principles and rules governing safe harbor deferred exchanges in the regulations have found a new home in Revenue Procedure 2000-37, which governs safe harbor reverse exchanges. Perhaps emboldened by the deferred exchange Regulations, taxpayers began engaging in a variety of “parking” transactions in which an accommodator (i) acquired and “parked” replacement property while improvements were made and then exchanged it with the taxpayer (exchange last); or (ii) acquired replacement property, immediately exchanged with the taxpayer, and “parked” the relinquished property until a buyer could be found (“exchange first”).

B. Theory of IRS Challenge to Reverse Exchanges

In a typical reverse exchange parking arrangement, an accommodator holds replacement property. The IRS could argue that the accommodator is acting as the taxpayer’s agent. If this were the case, the taxpayer could be considered to be in constructive receipt of the replacement property, and therefore could not acquire it from himself in an exchange. However, Rev. Proc. 2000-37 provides that as long as the reverse exchange is structured to fall within the safe harbor, the IRS will not challenge qualification of property as either replacement property or relinquished property, and will not treat the accommodator as the agent of the taxpayer.
C. **Rationale for Engaging in Reverse Exchange**

Why would a taxpayer contemplate a reverse exchange? A situation calling for a reverse exchange might arise where the cash buyer of the property to be relinquished has defaulted, and the taxpayer must take title to the replacement property immediately or risk forfeiting the down payment. There are two types of reverse exchanges: “Non-safe harbor” (or “pure”) reverse exchanges; and reverse exchanges under Revenue Procedure 2000-37. The familiar 45-day identification and 180-day exchange periods found Section 1031(a)(2) and which govern all deferred exchanges have been engrafted onto Revenue Procedure 2000-37. Non safe harbor reverse exchanges have no identification or exchange period requirements *per se*. Although the Revenue Procedure 2000-37 safe harbor provides a degree of certainty not possible using a non safe harbor reverse exchange, the time constraints imposed by Revenue Procedure 2000-37 may pose an insurmountable problem. If so, a non safe harbor reverse exchange may be the only option. However, difficult issues of agency and constructive receipt absent in safe harbor reverse exchanges under Revenue Procedure 2000-37 may well arise in a non safe harbor reverse exchanges.

D. **Promulgation of Revenue Procedure 2000-37 Safe Harbor**

Rev. Proc. 2000-37 was born of an attempt by the IRS to provide a safe harbor that allows taxpayers intending to complete a like-kind exchange after acquiring replacement property to accomplish that result in a predictable fashion. Although the deferred exchange regulations do not govern reverse exchanges, many of its rules and time periods have been “borrowed” by Rev. Proc. 2000-37. The 45-day period limits the time in which the taxpayer may identify up to three properties to be relinquished in an “Exchange Last” reverse exchange. The 180-period limits the time in which the taxpayer must relinquish one of those three identified properties. The 180-day period also applies with respect to the accommodator. The 180-day period limits the time in which an accommodator may hold and improve replacement property in an Exchange Last reverse exchange. The 180-day period also limits the time in which an accommodator may hold relinquished property for sale in an “Exchange First” reverse Exchange. Reverse exchanges under Rev. Proc. 2000-37 are effective with respect to an “Exchange Accommodation Titleholder” (EAT) that acquires beneficial title in either the relinquished or the replacement property. The IRS will not challenge the qualification of either replacement or relinquished property, or the status of the EAT as owner for federal income tax purposes of such property, if the property is held in a “qualified exchange accommodation arrangement.” (QEAA). The EAT in a QEAA may hold the exchange property for no more than 180 days. Under Rev. Proc. 2000-37, the EAT is treated as the owner of property for federal income tax purposes. To be the tax owner, the EAT must possess “qualified indicia of ownership” (QIO) from the acquisition date until the date the property is transferred. The taxpayer may continue to lease or manage the property while it is parked with the EAT. The EAT cannot be either the taxpayer or a “disqualified person.” Disqualification is determined under rules similar to those found in deferred exchange Regs. § 1.1031(k)-1(g).

1. **Distinguish QI and EAT**

The role of the QI is also distinguishable from that of the EAT in that the
QI never acquires beneficial title in either the relinquished or the transferred property (and not even legal title if property is direct-deeded to the taxpayer) while the EAT must be the beneficial owner for tax purposes. Neither the QI nor the EAT is the taxpayer’s agent for federal income tax purposes. However, the QI may be the taxpayer’s escrow agent for legal purposes, and may be the taxpayer’s agent for local (i.e., transfer tax) purposes. Since an escrow agent is bound by a fiduciary obligation, Regs. § 1.1031(k)-1(g)(3) provides that the taxpayer is not in constructive receipt of exchange funds held by the QI.

2. Qualified Exchange Accommodation Arrangement

The IRS will not challenge the qualification of either replacement property or relinquished property, or the status of the exchange accommodation titleholder (EAT) as the beneficial owner of such property, if the property is held pursuant to a “qualified exchange accommodation agreement” (QEAA). Revenue Procedure 2000-37 is effective with respect to an EAT that acquires legal or beneficial title on or after September 15, 2000. The QEAA will provide that the EAT is not the taxpayer’s agent for federal tax purposes.

a. Qualified Exchange Accommodation Arrangement

Property is deemed to be held pursuant to a QEAA only if the following six conditions are satisfied:

(1) Qualified Indicia of Ownership Held by Exchange Accommodation Titleholder

The EAT must possess “qualified indicia of ownership” (QIO) from the date of acquisition until the property is transferred. QIO comprehends a situation in which the EAT possesses (i) legal title; (ii) beneficial title under principles of commercial law (i.e., a contract for deed); or (iii) interests in a disregarded entity such as a single-member LLC that itself holds legal title to property. Although the EAT must possess beneficial title, the EAT need not either acquire any equity interest or assume any risk.  

Prior to the safe harbor provided under Rev. Proc. 2000-37, an accommodation party was required to have an ownership interest in the property in order to avoid constructive receipt by the taxpayer. The accommodation party was typically required to contribute at least 5% and up to 20% of the cost of the replacement property. Contractual relationships between the accommodation party and the taxpayer were (continued...)
involving non-safe-harbor reverse exchanges. The EAT cannot be either the taxpayer or a “disqualified person.” The EAT must be subject to and report federal income tax.

(a) Disqualified Person

A disqualified person under Regs. § 1.1031(k)-1(k) is a person who is (i) an agent of the taxpayer (e.g., the taxpayer’s employee, attorney, accountant, investment banker or broker, or real estate agent or broker; (ii) a person with whom the taxpayer bears a relationship described in either Section 267(b) or Section 707(b), determined by substituting in each section “10 percent” for “50 percent”; or the person and an agent of the taxpayer, as defined in (i) who bears the relationship described in (ii). Essentially, the rules parallel those for persons who are disqualified from acting as qualified intermediaries in deferred exchanges under the Regulations.

(b) Services of EAT Not Taken Into Account

Services for the taxpayer in connection with the person’s role as the EAT in a QEAA are not taken into account in determining whether that person or a related person is a disqualified person. However, even though property will not fail to be treated as being held in a QEAA by

22(...continued)
required to be of arm’s-length, to preserve the legal fiction of the accommodation party being the owner of the property. A qualified intermediary was still needed, since the taxpayer might otherwise be considered in constructive receipt of funds transferred to the accommodation party.
reason of services provided by the
EAT, the IRS may recast an amount
paid pursuant to such an
arrangement as a fee paid to the
EAT to the extent necessary to
reflect the true economic substance
of the arrangement.

(2) Intention to Effectuate
Section 1031 Exchange

At the time QIO is transferred to the EAT, the taxpayer must intend that such property represent either the replacement property or the relinquished property in an exchange intended to qualify under Section 1031.

(3) Qualified Agreement with EAT

No later than five business days after the transfer of qualified indicia of ownership to the EAT, the taxpayer and the EAT must enter into a written agreement, the “qualified exchange accommodation agreement” (QEAA) which provides that (i) the EAT is holding the property for the benefit of the taxpayer to facilitate an exchange under Section 1031 and Revenue Procedure 2000-37; (ii) the parties agree to report the acquisition, holding, and disposition of the property as provided for in Revenue Procedure 2000-37; (iii) the EAT will be treated as the beneficial owner of the property for all federal income tax purposes; and (iv) both parties will report the transaction in a manner consistent with the agreement.

(4) 45-Day Period to Identify
Relinquished Property

No later than 45 days after the transfer of qualified indicia of ownership to the EAT, the relinquished property must be identified in a manner consistent with the principles described in the deferred exchange Regulations. Regs. § 1.1031(k)-1(c). (The taxpayer may also properly identify alternative and multiple properties, as
provided inRegs. § 1.1031(k)-1(c)(4). Thus, the taxpayer must furnish written notice to the EAT concerning the identity of the relinquished property by no later than midnight on the 45th day following acquisition of replacement property. 23 [The identification requirement would, by definition, have no application in the exchange first format, where the taxpayer at the outset transfers relinquished property to the accommodator, who immediately exchanges it for replacement property which the accommodator has purchased.]

(5) Sale of Property Within 180-Day Period

No later than 180 days after the transfer of legal title to the EAT, the property must be transferred (i) directly or through a QI to the taxpayer as replacement property (“exchange last” format), or to a person (other than the taxpayer or a disqualified person) as relinquished property (“exchange first” format).

(6) Combined Time Period

The combined time period during which the relinquished and the replacement property may be held in a QEAA cannot exceed 180 days.

b. Permissible Agreements

Property will not fail to be treated as being held in a QEAA by reason of any of the following contractual arrangements, even if such arrangements would not typically result from arm’s length bargaining.

(1) EAT May Be QI

23 Unlike forward deferred exchanges involving a QI, the taxpayer cannot assume that the identification requirement will have been satisfied by the actual acquisition of replacement property within 45 days. Unlike the situation involving a QI in a safe-harbor deferred exchange, the EAT in a reverse exchange might be “outside the loop,” as the QI in the reverse exchange would acquire the replacement property. Therefore, even if property is acquired by the taxpayer through the QI within 45 days, the property should be identified and the EAT should be so advised. It would be unwise to assume that the IRS would not argue otherwise. See PLR
An EAT that satisfies the requirements of the QI safe harbor set forth in Regs. § 1.1031(k)-1(g)(4), and is not a disqualified person, may enter into an exchange agreement with the taxpayer to serve as the QI in a simultaneous or deferred exchange. Thus, qualified intermediaries and title companies may provide all of the services typically needed to effectuate a like-kind exchange. The same person may be the EAT for the acquisition of the replacement property as well as the QI in the sale of the relinquished property.

(2) Guarantee of Obligations of EAT

The taxpayer or a disqualified person may (i) guarantee all or some of the obligations of the EAT, including secured or unsecured debt incurred to acquire the property, or (ii) indemnify the EAT against costs and expenses.

(3) Funds May be Loaned to EAT

The taxpayer or a disqualified person may extend loans or advance funds to the EAT, or guarantee a loan or advance to the EAT. The loan need not bear interest, and there need not be any charge imposed for the loan guarantee.

(4) Property Leased by EAT to Taxpayer or Other Disqualified Person

The EAT may lease property to the taxpayer or a disqualified person. Rev. Proc. 2000-37 does not impose the requirement that any rent be paid to the EAT. Nevertheless, in practice the taxpayer will be required to remit to the EAT an amount equal to the debt service on a loan (if any) used to acquire the property.

(5) Taxpayer or Other Disqualified Person May Manage Property

The taxpayer or other disqualified person may manage the property, supervise improvement of the property, act as a contractor, or otherwise
provide services to the EAT with respect to the property. Thus, although the EAT actually owns the property, the taxpayer will be responsible for improvements being made.

3. **Puts and Calls**

The taxpayer and the EAT may enter into arrangements and agreements regarding the purchase and sale of the property, including puts and calls relating to the purchase or sale of property, provided they are effective for not more than 185 days from the date the property is acquired by the EAT.

a. **“Make Whole” Provision**

In an “exchange first” transaction, the EAT acquires ownership of the relinquished property and may hold that property for a period of 180 days. During that time, the EAT is subject to the risk that value of the relinquished property might change. To avoid this result, the QEAA may permit the taxpayer and the EAT to enter into agreements and arrangements providing that any variation in the value of a relinquished property be taken into account upon the EAT’s disposition of the relinquished property.

4. **Other Tax Treatment**

Property will not fail to be treated as being held in a QEAA merely because the federal income tax treatment differs from the accounting, regulatory, or state, local or foreign tax treatment of the arrangement between the EAT and the taxpayer. Therefore, although the EAT must be the owner for federal income tax purposes, it need not be the owner for other purposes.

5. **State and Local Tax Treatment**

In order to avoid a second imposition of transfer taxes, most QEAA arrangements attempt to treat the EAT as the taxpayer’s agent for state and local purposes.


Many transactions, particularly “build-to-suit” arrangements, will not qualify under the Revenue Procedure 2000-37 safe harbor since the improved replacement property cannot be acquired within 180 days. If the EAT is a disqualified person, or it is necessary to go beyond 180 days, the taxpayer can still pursue a “pure” reverse exchange. Section 3.02 of the Revenue Procedure provides that “the Service recognizes that parking transactions can be
accomplished outside of the safe harbor” and states that “[n]o inference is intended with respect to ... arrangements similar to those described in this revenue procedure.” PLR 200111025 recognized that non-safe-harbor reverse exchanges survive Revenue Procedure 2000-37. Nonetheless, the safe harbor does appear to reflect the view of the IRS with respect to reverse exchanges in general. Stringent disqualification rules found in Revenue Procedure 2000-37, which substitute “10 percent” for “50 percent” under Sections 267(b) and 707(b) would, by definition, have no application in non safe harbor reverse exchanges. However, non-safe-harbor reverse exchanges would still be subject to the related party rules themselves, which also reference Sections 267(b) and 707(b), albeit without varying the “50 percent” language found in those sections.

a. **Obstacle to Non-Safe-Harbor Reverse Exchange**

If qualification under the safe harbor becomes problematic, the taxpayer could fall back on non-safe harbor qualification as a final resort. However, many of the permissible arrangements under Revenue Procedure 2000-37 would cause a non-safe harbor reverse exchange to violate agency or constructive receipt rules governing Section 1031 exchanges in general. In other words, stripped of the safe harbor protection of Rev. Proc. 2000-37, the Service could argue that the EAT was the taxpayer’s agent. Therefore, as a practical matter, non-safe harbor qualification may prove difficult if the transaction was originally intended to qualify under Revenue Procedure 2000-37.

7. **When Reverse Exchanges Should be Contemplated**

The requirement that the EAT obtain legal title to the parked property makes reverse exchanges relatively costly. Accordingly, their use should be reserved to situations where a deferred exchange is impossible, such as where the relinquished property buyer has defaulted, or where improvements must be commenced prior to disposition of the relinquished property. If improvements can be completed within the 180-day period in which the property may be parked with the EAT, Rev. Proc. 2000-37 provides a degree of certainty. However, if more time is required for construction, a non-safe-harbor reverse exchange may be the only option. The validity of a pure reverse exchange will depend upon whether the accommodator is respected as tax owner, or is merely deemed the taxpayer’s agent. Just as pre-regulation case law remains relevant in resolving deferred exchange disputes, decisions predating Rev. Proc. 2000-3/7 are presumably still relevant in resolving disputes arising in reverse exchanges.
8. **Distinguish: Role of Qualified Intermediary**

The deferred exchange regulations provide that the interposition of a qualified intermediary to receive exchange funds liberates the taxpayer from problems of constructive receipt and agency, which normally plague like kind exchanges. A qualified intermediary may acquire legal title, though through direct deeding, often this is not the case. Whether or not the qualified intermediary acquires legal title, the QI never acquires beneficial title in either the relinquished or replacement property. Most importantly, the qualified intermediary is not considered the taxpayer’s agent for federal tax purposes. The “exchange accommodator titleholder” (EAT) in a reverse exchange, by contrast, will acquire legal title to either the relinquished or the replacement property. Whereas neither the QI nor the EAT is considered the taxpayer’s agent for federal tax purposes, the EAT must be the tax owner of the property in a reverse exchange, since it is the EAT – and not the taxpayer – who is engaging in the like kind exchange. For taxpayers wishing to “opt out” of the safe harbor reverse exchange, a non safe harbor reverse exchange nominally at least imposes no jurisdictional time periods. Of course, issues of agency and constructive receipt could doom many reverse exchanges which proceed outside of the safe harbor.

E. **Exchange Last Format**

Rev. Proc. 2000-37 sanctions two types of reverse exchanges: Exchange Last and Exchange First. In Exchange Last, an accommodator (EAT) acquires and “parks” replacement property until the taxpayer arranges to dispose of the relinquished property through a QI. (The taxpayer must identify property to be relinquished within 45 days of the EAT acquiring title to the replacement property.) Financing for the acquisition may be arranged by the taxpayer. The QI transfers proceeds from the relinquished property sale to the EAT in exchange for the parked replacement property. The EAT then transfers the replacement property directly to the taxpayer, completing the exchange. The EAT uses the cash received from the QI to retire the debt. While parked with the EAT, the replacement property may be net-leased or managed by the taxpayer.

F. **Steps in Exchange Last Reverse Exchange**

1. The Exchange Accommodation Titleholder (EAT) creates an LLC to hold title to the replacement property which it will acquire pursuant to the Qualified Exchange Accommodation Agreement (QEAA).

2. The QEAA provides that the taxpayer will assign to the EAT all contractual rights to purchase the replacement property, after which the EAT will convey title in the replacement property to the taxpayer at such time as the taxpayer
conveys title to the property being relinquished.

3. Financing for the purchase of replacement property by the EAT will be provided by the taxpayer or by the seller of the replacement property, or by the EAT itself.

4. The EAT will enter into a six-month triple net lease (taxes, insurance, debt service) agreement with the taxpayer whereby the replacement property is leased to the taxpayer for a nominal amount of rent (e.g., $100/month).

5. The taxpayer will identify, within 45 days, property to be relinquished, pursuant to the normal identification rules (e.g., 3-property rule, 200% rule). The taxpayer must acquire title to the replacement property within 180 days.

6. Pursuant to the QEAA, the EAT will be obligated to sell the replacement property to the qualified intermediary (QI) once the QI holds the proceeds from the sale of the taxpayer’s relinquished property. (The EAT is not a party to the exchange agreement between the taxpayer and the QI.)

7. The QI will cause the relinquished property to be sold, with the taxpayer direct-deeding title to the relinquished property to the purchaser. The QI will use the proceeds to purchase the replacement property from the EAT, resulting in the EAT conveying title in the replacement property directly to the taxpayer. This will complete the like kind exchange.

8. The net proceeds from the sale of the relinquished property will be used first to pay costs of the sale (transfer and recording fees and taxes, title insurance, etc.), and then to satisfy the indebtedness incurred by the EAT to purchase the replacement property. If the net proceeds are insufficient, the taxpayer will provide additional funds to the EAT. The remaining cash may be used by the taxpayer to acquire other like kind exchange property, subject to the 45-day identification and 180-day deferred exchange requirements. See, e.g., CCA 200836024, infra, (H)(4).

G. Advantages of Exchange Last

Since the parked property will have been initially acquired by the accommodator and will not have been previously owned by the taxpayer, there is little risk the accommodator will be disregarded for tax purposes. Another advantage of Exchange Last is that following acquisition by the accommodator of the replacement property, the taxpayer can consider several potential properties to be relinquished, and ultimately choose that which generates the least gain. However, if the taxpayer elects to proceed under the safe harbor provided by Rev. Proc. 2000-37, flexibility will be limited, since the taxpayer must identify three potential properties
to be relinquished within the 45-day identification period.

1. **EAT Title Owner of Property**

   While the replacement property is parked with the EAT, the EAT is title owner of that property. Therefore, the EAT will be the borrower on a loan associated with the acquisition of the replacement property until the loan is satisfied by proceeds from the sale of the relinquished property. To avoid loan application problems, the taxpayer should apprise the lender at an early stage of the planned reverse exchange and the presence of the EAT.

2. **Build-to-Suit Exchanges Employ Exchange Last**

   A build-to-suit exchange would typically employ the Exchange Last format, since the replacement property may be improved while parked with the accommodator. Many “build-to-suit” arrangements will not be suitable for the Rev. Proc. 2000-37 safe harbor, since completion of improvements may not be possible within the 180-day period in which the property is held by the EAT.

3. **Non-Safe-Harbor Exchange Last in Build to Suit**

   If it is necessary to go beyond 180 days (or if the EAT is a “disqualified person”) the taxpayer can still a pursue “non-safe-harbor” or “pure” reverse exchange. Rev. Proc. 2000-37 states that “the Service recognizes that parking transactions can be accomplished outside of the safe harbor.” PLR 200111025 explicitly recognized that non-safe-harbor reverse exchanges survive Rev. Proc. 2000-37. Pure reverse exchanges free the taxpayer of constraints imposed by the 45-day identification period and the 180-day period during which the accommodator may improve the replacement property. However, pure reverse exchanges pose more tax risk, as they are burdened with issues of agency, constructive receipt and beneficial ownership. Therefore, if more than 180 days are required, and a planned safe harbor Exchange Last reverse exchange is converted into a non-safe-harbor reverse exchange, liberties taken when planning under the safe harbor may have doomed a non-safe-harbor reverse exchange unless these troublesome issues are considered from the start.

H. **Exchange First Format**

   The second type of safe harbor reverse exchange is “Exchange First.” Here, the taxpayer sells relinquished property to an EAT through a QI. Shortly thereafter, the QI uses the sale proceeds to purchase replacement property, which is transferred directly to the taxpayer, completing the exchange. Although the exchange is complete, the EAT may continue to retain the relinquished property for up to 180 days, until the taxpayer arranges for a buyer. Since the replacement property is transferred directly to the taxpayer, the EAT never acquires ownership in the
replacement property. This eliminates the requirement that the EAT be involved in the loan process. It also eliminates the necessity of the EAT taking legal title, which may be advantageous from a transfer tax standpoint. Since the taxpayer is taking title to the replacement property immediately, it may be pledged as collateral for a loan. If management problems exist, it may also be preferable for the taxpayer to take immediate ownership in the replacement property. An Exchange First reverse exchange might be desirable if the purchaser of the property to be relinquished has defaulted, leaving the taxpayer obligated to close on the replacement property or risk losing his down payment. The taxpayer could acquire the replacement property before finding a new buyer for the relinquished property. By structuring an Exchange First reverse exchange under the Rev. Proc. 2000-37 safe harbor, the taxpayer sacrifices the luxury of time, since he may no longer wait 45 days to identify potential properties to be relinquished, nor wait 180 days to choose among those properties that property to be relinquished. Instead, the taxpayer must choose the property to be relinquished when the replacement property is acquired, and must actually relinquish it, since the QI must have the sales proceeds in hand to acquire the replacement property. The only applicable time constraint in a safe harbor Exchange First reverse exchange is the 180-period during which the EAT must dispose of parked relinquished property.

I. Cases and Rulings Involving Reverse Exchanges

1. The “Unplanned Reverse Exchange” – TAM 200039005

In TAM 200039005, a typical deferred exchange with a qualified intermediary was contemplated until the cash buyer failed to obtain financing. To avoid losing his deposit on the replacement property and to preserve exchange treatment, the taxpayer structured a hasty “exchange last” parking arrangement with the accommodator, in which the accommodator took legal title to the replacement property. Pursuant to an oral agreement, the taxpayer (i) provided financing and remained personally liable on the loan for the replacement property and (ii) continued to occupy the parked replacement property without a formal lease. The taxpayer then assigned the contract for the relinquished property to the accommodator. At closing, the accommodator transferred title (i) in the replacement property to the taxpayer and (ii) in the relinquished property to the cash buyer.

a. Taxpayer’s Argument

The taxpayer argued that (i) the transaction qualified as a deferred exchange with a QI under the safe harbor Regulations since the accommodator was acting as QI; (ii) the accommodator could act as agent under the deferred exchange Regs. § 1.1031(k)-1(g)(4)(i); and (iii) a qualifying like kind exchange can occur without regard to the order in which the QI performs its functions.
b. **IRS Argument**

The IRS argued that (i) the accommodator was acting as the taxpayer’s agent or nominee in acquiring replacement property; (ii) the safe harbor does not apply to reverse exchanges; and (iii) even if the safe harbor could apply to reverse exchanges, there was no written exchange agreement in place with accommodator at the time replacement property was acquired from the cash seller. The transactions also reflected a lack of intent to effect an exchange, since the cash buyer was not part of the transaction when the accommodator acquired title to the replacement property.

(1) **Weakness in IRS Argument**

Beyond the agreement of the QI and the taxpayer, there is no requirement of mutuality of intent among other parties to an exchange. Neither the cash buyer nor the cash seller is typically a party to the exchange or intends to complete an exchange. Nevertheless, taxpayer’s position would have been strengthened had an exchange agreement been entered into with the cash seller prior to the initial closing.

c. **Upshot of TAM 200039005**

Since that the taxpayer supplied funds for the parked property, was personally liable on mortgage, and had exclusive use of the parked property, it is not surprising that the IRS asserted the existence of an agency. Careful planning should avoid problems raised in the TAM.

2. **DeCleene v. Comr. – “Planned” Build-to-Suit Reverse Exchange**

a. **Facts**

*DeCleene v. Com’r*, 115 T.C. No. 34 (2000) was decided after Revenue Procedure 2000-37. *DeCleene* purchased unimproved land on Lawrence Drive, where it intended to build and relocate. Shortly thereafter, WLC expressed interest in other property owned by *DeCleene*. To accommodate *DeCleene*’s desire to effectuate a like kind exchange, WLC agreed to purchase the Lawrence Street property and improve it, and then transfer it back to *DeCleene* in exchange for the other property WLC desired. The consideration paid by WLC for the Lawrence Street property consisted of a non-recourse, interest-free promissory note for $142,000. The
construction by WLC and the exchange were to both occur within a few months. To finance construction, Decleene guaranteed a $380,000 non-recourse bank loan to WLC. Decleene also paid WLC’s construction costs and real estate taxes. At closing, (i) WLC tendered $142,000 and title to the improved Lawrence Street property and (ii) Decleene tendered title to the other property and assumed WLC’s $380,000 loan.

b. **Tax Court Denies Exchange Treatment**

Finding that Decleene had never relinquished ownership of Lawrence Drive to WLC, the Tax Court denied what it characterized as an attempted reverse exchange. The court found significant Decleene’s failure to engage an accommodator, and questioned whether the $142,000 paid to the Decleene at closing constituted payment under the note, given initially by WLC to purchase the Lawrence Street property, which the parties professed to intend, or simply represented cash payment for the other property which WLC desired. If the $142,000 were simply payment for the other property, no exchange occurred.

c. **Problems with Transaction as Structured**

Had the $142,000 actually been paid to Decleene initially, WLC would have possessed the benefits and burdens of ownership. However, WLC made no economic outlay during the brief period of construction, bore no exposure for real estate taxes (or any liabilities during the three-month period), and had no potential for economic gain or loss during the period. Accordingly, WLC was never the tax owner of Lawrence Drive. The court intimated that an exchange might have occurred had the parties utilized an accommodator rather than a cooperative buyer. *Bloomington Coca-Cola Bottling* was cited for the for the proposition that a taxpayer cannot exchange property for other improved property owned by him. Decisions favorable to the taxpayer, such as *Coastal Terminals* and *Boise Cascade*, were distinguished in that in those cases the taxpayers (i) had never owned the property on which the improvements were made and (ii) had used their own funds to finance construction.

d. **Avoiding Problems in DeCleene**

*DeCleene* represented an unusual IRS victory where the form of transaction constituted an exchange. Most build-to-suit reverse exchanges can be structured to avoid the problems encountered in *DeCleene*. Ideally, the taxpayer should not own the replacement
property prior to exchange. If it does, an accommodator (rather than a cooperative buyer) should truly obligate itself with respect to the replacement property. In addition, (i) the taxpayer should not pay or be obligated to pay real estate taxes; (ii) the accommodator should have some equity risk (e.g., use its own funds or obtain recourse financing); and (iii) the time frame should be enlarged to avoid the risk of the application of the step-transaction doctrine. (The cooperative buyer was obligated to improve and reconvey the property within four months).

3. **CCA 200836024 – Reverse and Deferred Exchanges Combined**

In CCA 200836024 the taxpayer, pursuant to Rev. Proc. 2000-37, structured an “exchange last” reverse exchange and a deferred exchange. In the reverse exchange, Greenacre was acquired by the EAT and parked until the taxpayer identified property to be relinquished. Thirty-three days after Greenacre was acquired by the EAT, the taxpayer identified three properties to potentially serve as relinquished property for Greenacre. Redacre was one of those properties. On the 180th day following the EAT’s acquisition of Greenacre, Redacre was relinquished property in the reverse exchange, and that exchange was unwound. However, since the value of Redacre far exceeded the value of Greenacre, the taxpayer intended to engage in a second like-kind exchange to defer the gain that remained after the exchange of Redacre for Greenacre. Accordingly, the taxpayer, 42 days after the sale of Redacre to cash buyer, identified three additional properties, which were intended to be additional properties for the exchange of Redacre. The issue was whether the taxpayer could utilize Redacre both as the relinquished property in a reverse exchange, and also as the relinquished property in a deferred exchange. Reasoning that the taxpayer had complied with identification requirements for both reverse and deferred exchange, the advisory concluded that the taxpayer could properly engage in both a reverse and a deferred exchange with respect to the same property. The advice further noted that Rev. Proc. 2000-37 anticipated the use of a qualified intermediary in a reverse exchange. Finally, the advice cited *Starker v. U.S.*, 602 F.2d 1341 (9th Cir. 1979) (transfers need not occur simultaneously); *Coastal Terminals, Inc., v. U.S.*, 320 F.2d 333 (4th Cir. 1963) (tax consequences depend on what the parties intended and accomplished rather than the separate steps); and *Alderson v. Com’r.*, 317 F.2d 790 (9th Cir. 1963) (parties can amend a previously executed sales agreement to provide for an exchange), for the proposition that courts have long permitted taxpayers “significant latitude” in structuring like-kind exchanges.
XV. **Build to Suit**

A. **Taxpayer Must Avoid Actual or Constructive Receipt**

Property may be improved or constructed while being “parked” with an accommodator prior to being exchanged. In such build-to-suit arrangements, as in other realms of Section 1031, the taxpayer must avoid actual or constructive receipt of exchange proceeds, as well as concerns about agency. In a QI or QEAA safe harbor, issues of agency and constructive receipt do not arise. The efficacy of build-to-suit arrangements outside of the QI or QEAA safe harbors depends on whether the accommodator has acquired sufficient “burdens and benefits” of ownership with respect to the parked property so that he is treated as the tax owner rather than as merely the taxpayer’s agent. A build-to-suit arrangement may even be structured with a related party, provided that party is not an agent of the taxpayer. The related party rules of Section 1031(f) would apply to such a transaction. A reverse exchange build-to-suit by definition employs the “exchange last” format, since the replacement property must be “parked” with an accommodator during the time when improvements are made or construction occurs, prior to the exchange with the taxpayer. Under Revenue Procedure 2000-37, the taxpayer may exert considerable control over the improvements to the replacement property; more so than in a non safe harbor reverse exchange. That is, even though the EAT holds beneficial or legal title, the taxpayer may direct the EAT to construct improvements according to the taxpayer’s specifications.

1. **Bloomington Coca-Cola v. Com’r**

*Bloomington Coca-Cola v. Com’r*, 189 F.2d 14 (7th Cir. 1951), held that an exchange of real property for services will not qualify under Section 1031. The taxpayer conveyed land and cash to a contractor in exchange for the construction of a bottling plant on other land owned by Coca-Cola. However, since the taxpayer already owned the land on which the plant was constructed, it was held to have received services and materials rather than qualifying real property in the exchange. (Deferred exchange Regulations § 1.1031(k)-1(e) similarly provide that “any additional production occurring with respect to the replacement property after the property is received by [the taxpayer] will not be treated as the receipt of property of a like kind.”)

2. **J.H. Baird v. Com’r**

In *J.H. Baird v. Com’r*, 39 T.C. 608 (1962), a real estate broker, for a fee, acquired title and constructed a facility according to the taxpayer’s specifications. Thereafter, the broker transferred the improved property to the taxpayer in exchange for other property owned by the taxpayer. Exchange treatment obtained since the broker, who earned a profit, had not acted as the taxpayer’s agent in selling the property and constructing the building.

3. **Coastal Terminals v. U.S.**
In *Coastal Terminals*, 320 F.2d 333 (4th Cir. 1963), the taxpayer assigned an option to acquire land on which the taxpayer desired a new facility to a prospective purchaser of other property owned by the taxpayer. The optionee constructed improvements in accordance with the taxpayer’s directions, and then transferred the improved property back to the taxpayer in exchange for the other property the optionee desired. A good exchange occurred, since the optionee used its own funds, and incurred its own obligations, in buying and building the facility for exchange with the taxpayer. The optionee was deemed the tax owner of the other property being improved.

4. **Revenue Ruling 75-291**

IRS Rulings and case law support the proposition that the taxpayer may remain actively involved in the construction process without jeopardizing exchange treatment, provided the work is completed before the taxpayer acquires the replacement property. In Revenue Ruling 75-291, Y acquired land and constructed a factory for the sole purpose of exchanging it for X’s property. Exchange treatment was accorded, since Y constructed the factory on its own behalf and not as an agent of X. Deferred exchange Regs. § 1.1031(k)-1(e) explicitly provides that replacement property may be constructed, and authorizes build-to-suit arrangements that have been adequately described during the identification period.

5. **Fredericks v. Com’r**

*Fredericks v. Com’r*, T.C. Memo 1994-27, decided prior to the enactment of the related party rules, held that a nontaxable exchange occurred where the taxpayer transferred an apartment complex to a wholly-owned corporation in exchange for the corporation’s promise to purchase undeveloped land, construct improvements, and convey the improved property to the taxpayer. *Fredericks* was successful in obtaining exchange treatment since (i) the taxpayer did not control sale proceeds prior to receiving the replacement property; (ii) the relinquished property was transferred and replacement property was received as part of an integrated plan; and (iii) the related party did not act as the agent of the taxpayer.

a. **Application of Related Party Rules**

Section 1031(f)(1) provides that if a taxpayer exchanges property with a related party and within two years, either the taxpayer or the related party disposes of property received in the initial exchange, any gain deferred in the initial transaction will be recognized as of the date of the later disposition. *Fredericks* was decided prior to the enactment of the related party rules. To avoid the application of related party rules, Section 1031(f)(2)(C) would today require the taxpayer to demonstrate that the transaction was not motivated by a tax avoidance purpose.
6. **PLR 200901004**

In PLR 200901004, the IRS ruled favorable regarding an exchange where taxpayer, engaged in the business of processing minerals in Old Facility, assigned easements to its wholly-owned LLC, which would then construct New Facility also for the purpose of processing minerals. The LLC would acquire funds for project financing through a syndicate of third party lenders, and the financing would be secured by the New Facility. Lenders would have the right to foreclose on the New Facility, including the LLC’s rights under the assigned easements. The ruling noted that the proposed exchange between the LLC and the taxpayer, though qualifying under Section 1031, constituted an exchange of multiple properties, both tangible and intangible, pursuant to Tres. Regs. § 1.1031(j)-1. This necessitated a property-by-property comparison to determine the extent of any boot present in the exchange.

7. **Role of Qualified Intermediary**

If sufficient improvements to the replacement property can be made within the 180-day exchange period, construction is typically done by the QI. Note that the QI must (i) acquire title; (ii) pay for the improvements; and (iii) transfer the replacement property to the taxpayer prior to the end of exchange period. Regs. §1.1031(k)-1(g)(4) permits the QI to be the designated agent of the taxpayer. This may eliminate a second transfer tax and also facilitate construction financing. A QI could presumably pay construction costs incurred during the 180-day exchange period.

a. **PLR 9428077**

In PLR 9428077, the QI acquired property from the taxpayer, transferred the property to a cash buyer, and used the funds to acquire replacement property and build a golf course. Prior to the end of the exchange period, the QI transferred the golf course to the taxpayer. Exchange treatment ensued, since the QI had sole authority to control the funds, and the taxpayer had no right to receive, pledge, borrow or otherwise obtain the benefits of the cash, other than to select improvements.

b. **Improvements Require More Than 180 Days**

If more than 180 days are required to construct improvements, the taxpayer may have no choice but to structure the transaction as a non-safe harbor reverse exchange, since only then can the taxpayer avoid the 180-day jurisdictional limitation imposed by Section
1031(a)(3)(B) for deferred exchanges and by Revenue Procedure 2000-37 for safe harbor reverse exchanges. Again, the accommodator in a non-safe harbor build-to-suit exchange should bear some risk of loss and incur some legal obligations.

XVI. Tenancy-in-Common Interests and Undivided Fractional Interests

A. Increased Popularity of TIC Interests

Tenancy in common (TIC) interests have become extremely popular as replacement properties. A TIC interest represents a slice of a larger fee interest. Ownership is evidenced by an individual deed stating an undivided ownership interest in the TIC property. A TIC owner possesses the same rights as would a sole owner. Given the recent popularity of TICs as replacement property, the most desirable TIC investments command a substantial premium. On the other hand, costs associated with the TIC ownership also reflect economies of scale. Since multiple owners may pool their resources, a TIC interest in high quality commercial property may be acquired for as little as $200,000. Since a smaller investment is required, there is a greater opportunity to diversify. TIC properties generally consist of high quality triple net leased buildings, or large retail or office buildings costing $1 million to more than $10 million. TICs provide a relatively secure monthly cash flow, since most tenants are creditworthy and commit to multi-year leases. The TIC sponsor will typically provide quarterly updates and annual reports. As the taxpayer builds equity in the TIC, it may be possible to trade up with sequential Section 1031 exchanges.

B. Role of Sponsor

A TIC sponsor will generally have placed the property under contract, constructed it, or purchased it for exchange. The sponsor analyzes leases, assesses maintenance requirements, conducts demographic studies, and determines desirable investment property. The sponsor may enter into a master lease with the TIC interest holders, and then lease the property to subtenants. Individual TIC interest holders will have little if any day-to-day management responsibility, making the investment particularly appealing for property owners who wish to minimize their level of involvement in replacement property. A TIC property marketed through a Private Placement Memorandum (PPM) can often be identified and closed within the 45-day identification period. A second TIC property owned by the sponsor can also be identified as backup replacement property. Before a TIC property is acquired, a business plan of three to seven years, as well as an exit strategy, may already be in place. A TIC lender will typically look for high debt coverage ratios and insist that sufficient reserves are placed in escrow to provide for future vacancies. The duration of a pre-arranged nonrecourse loan may be structured to coincide with the business plan, maximizing the benefit of current market rate interest options.

C. Tax Issues Involving TICs

The term “securities” has a different meaning for securities law and tax law purposes. Under the securities law, the term is defined broadly, while under the tax law, the term is defined narrowly. For purposes of Section 1031, the definition of “security” appears to be limited to a stock, bond or
note. Thus, there is little likelihood that an interest in a TIC or a DST would violate Section 1031(a)(2)(D), which prohibits the exchange of securities in a like-kind exchange. Even though TICs and DSTs constitute real property for tax purposes, they may constitute “securities” for purposes of the securities laws. A security is an investment in which a person other than the taxpayer manages the investment with a view to receiving income and achieving capital gain. The manager of a TIC would appear to be such other person. If TICs do constitute securities for purposes of the securities laws, they should be sold only by brokers to “accredited” investors through a Private Placement Memorandum (PPM), which discloses risks. Congress appears to have become concerned over the recent widespread marketing of TICs as real estate, often on the internet. Farmers have complained that TICs are putting unwarranted upward price pressure on farm land. Congress also appears to be concerned about “leverageing” for estate tax purposes. Taxpayers have acquired TICs and then dropped them into LLCs or partnerships that generate valuation discounts. If a taxpayer claims a gift or estate tax discount for both the TIC interest and the partnership interest, total discounts of 40 percent or more can be claimed.

1. Illustration

Taxpayer owns a shopping center on Long Island worth $7,500,000, with a mortgage of $5,000,000. Using the 200 percent rule, the taxpayer identifies the following TIC properties within the 45-day identification period: (i) a Class A 300,000 square foot distribution center in Chicago; (ii) a new 265 unit apartment community in Las Vegas; (iii) a shopping center in New Orleans; and (iv) an oil and gas interest in Alaska. The taxpayer closes on three of the properties within the exchange period. The fourth property was identified as a backup. Not only has the taxpayer diversified his investment, but he has chosen a mix of properties with differing cash flows and investment potential. For example, the distribution center in Chicago may have a high cash flow (i.e., capitalization); the New Orleans shopping center may offer unique federal and state tax advantages; the Las Vegas apartments may possess enhanced growth potential; and the Alaska oil and gas lease may offer attractive current write-offs.24


The taxpayer’s counsel will first review the sponsor’s PPM. Since the taxpayer may borrow to “trade up” in value, the lender will typically require (i) a current financial statement; (ii) tax returns for the previous three years; and (iii) a schedule of real estate owned. Information regarding the form of ownership of the relinquished property will also be required, e.g., trust, LLC, corporation or partnership with associated documentation such as trust indenture, operating or partnership agreements or by-laws. The sponsor will typically form a special

24 Oil and gas leases, which constitute an interest in real property for purposes of Section 1031, are entitled to a 15 percent yearly depletion allowance. However, if such a lease is disposed of in a taxable transaction, recapture income will result to extent gain exceeds the original investment.
purpose entity limited liability company (SPE LLC) to hold the TIC interests. A purchase agreement and escrow instructions will accomplish the acquisition of the TIC interest; a TIC agreement will govern the rights of the tenants in common; and a property management agreement will be entered into by the tenants to manage the property. Tenants in common will typically be required to either sign a loan assumption agreement or agree to assume liability on all of the loan documents.

D. IRS Response to TIC Activity: Revenue Procedure 2002-22

Section 1031(a)(2)(D) bars the exchange of partnership interests in a like kind exchange. Since a formal partnership agreement is not required to tax co-owners of property as partners in a partnership, the lack of a formal partnership agreement does not mean that the TIC interests do not constitute a tax partnership. In response to explosion of TICs as replacement property, the IRS issued Revenue Procedure 2002-22, which permits acquisition of TIC interests by a group of owners, but prevents those TIC owners from operating as a de facto partnership. The ruling provides circumstances in which a group of small investors acquiring undivided interests in a larger single-tenant replacement property will be viewed as acquiring TIC interests or undivided fractional interests (UFIs), rather than as partnership interests. At one time, PPMs contained a designation that the offering was “Revenue Procedure 2002-22 compliant.” However, as it became clear that certain conditions of Revenue Procedure 2002-22 were more important than others, and other guidance was issued, this designation was not as frequently made.

1. Neither Rule of Law Nor Safe Harbor

Revenue Procedure 2002-22 only provides a basis for obtaining a private letter ruling. It is not a substantive rule of law, nor does it provide a “safe harbor” for transactions involving TIC interests.

E. Conditions for Obtaining Tenancy In Common Ruling

Revenue Procedure 2002-22 sets forth information and documentation required to obtain a ruling request. The IRS will not consider a ruling request unless each of the conditions described below is satisfied. However, even if all of the conditions is satisfied, the IRS may decline to issue a ruling where that decision is warranted by the facts and circumstances and is in the interest of sound tax administration. The conditions are as follows (bold indicates important factor):

1. Tenancy-in-Common Title Ownership: Each owner must hold title to the real property as a tenant in common owner.

2. Number of Co-Owners: No more than 35 persons may be co-owners. Related parties (under sections 267(b) and 707(b) - a husband and wife for example) will be considered a single person for purposes of this requirement.

3. No Treatment of Co-Owners as an Entity: The co-owners may not file
partnership tax returns or in any way act as or hold themselves out to be a partnership.

4. Co-Ownership Agreement: The co-owners may enter into a limited co-ownership agreement that may run with the property. The agreement may authorize a co-owner to offer his portion of the property for sale to the other co-owners before marketing the property outside. The agreement may also provide for majority voting on some actions taken by the co-owners.

5. Unanimous Approval Required: The co-owners’ unanimous approval must be required for (i) any sale, lease or re-lease of all or a portion of the property; (ii) any negotiations or renegotiations of indebtedness secured by the entire property (“blanket lien”); (iii) the hiring of any manager; or (iv) the negotiation of any management contract, or any extension or renewal thereof.

6. Restrictions on Alienation: Each co-owner must have the right to transfer, partition and encumber his interest in the property without the approval of any person. However, lender restrictions that are consistent with common lending practices are permissible.

7. Creation of Blanket Liens: The co-owners must retain the right to approve the creation or modification of any blanket lien over the entire property, and any negotiations or renegotiations of indebtedness secured by the entire property. In addition, the lender may not be (i) a person related (under sections 267(b) or 707(b)) to any co-owner; (ii) the sponsor; (iii) the manager; or (iv) any lessee of the property.

8. Proportionate Sharing of Debt: The co-owners must share in any indebtedness secured by a blanket lien over the entire property in proportion to their undivided interests in the property.

9. Proportionate Sharing of Profits and Losses: Each co-owner must share in all the revenue generated by the property as well as all of the costs associated with the property in proportion to his interest. Neither the other co-owners, the sponsor, nor the manager, may advance funds to a co-owner to meet expenses associated with the property unless the advance is recourse and is for a period not exceeding 31 days.

10. Sharing Proceeds and Liabilities Upon the Sale of the Property: If the property is sold, any debt secured by the entire property (“blanket lien”) must be satisfied and the remaining proceeds must be distributed to the co-owners.

11. Options: Options may be issued by the co-owner, provided the exercise price
reflects the fair market value of the property determined at the time the option is exercised.

12. **No Business Activity:** The activities of the co-owners must be limited to those customarily performed in connection with the maintenance and repair of rental real estate.

13. **Management and Brokerage Agreements:** The co-owners may enter into management or brokerage agreements that are renewable no less frequently than annually. The manager or broker may be a sponsor or co-owner but may not be a lessee. The management agreement may authorize the manager to (i) maintain common bank accounts for the collection and deposit of rents and (ii) offset expenses associated with the property against any revenues before distributing each co-owner’s share of net revenues. The management agreement may also authorize the manager to take certain actions on behalf of the co-owners subject to the voting rules. Management fees may not exceed comparable fees paid to unrelated parties for similar services.

14. **Leasing Agreements:** All lease agreements must be *bona fide* leases for federal tax purposes.

15. **Payments to Sponsor:** Payments to the sponsor for the acquisition of the co-ownership interest and services must reflect the fair market value of the interest acquired and the services rendered. Therefore, such payments and fees may not depend, in whole or in part, on the income or profits derived from the property. For purposes of the ruling, a “sponsor” is defined as a person who packages co-ownership interests for sale by acquiring property, negotiating a master lease on the property, and arranging financing.

**F. Requirements Limit Practicality**

The requirement of Revenue Procedure 2002-22 that co-tenants not conduct business under a common name has been interpreted as barring advertising and banking transactions. This sharply limits the revenue procedure’s practicality. While an apartment complex could operate under the name “Hampstead Estates,” it could not operate under the name “Hampstead Estates Associates.” Similarly, the guidance appears to bar co-owners from taking fractionalization discounts, perhaps to discourage its use in estate planning. Nevertheless, Revenue Procedure 2002-22 is by its own terms inapplicable to audits, where the compliance threshold is likely to be lower. The determination of whether the arrangement is a co-ownership or a tax partnership is a question of federal tax law. State law has little relevance in determining federal tax entity classification. For example, California’s statutory presumption that title taken in co-ownership does not constitute partnership property would likely have no bearing on the federal tax determination.

1. **Recent Guidance From PLR 200513010**
Until recently, the IRS had issued little guidance with respect to how the taxpayer could meet the prolific requirements of Revenue Procedure 2002-22. Since replacement property must be identified within 45 days, the taxpayer has had to rely on tax opinions of counsel as to whether the requirements of Revenue Procedure 2002-22 were satisfied. PLR 200513010 ruled favorably on a multi-tenant net leased property with a blanket mortgage, stating that an undivided fractional interest (UFI) in rental real property owned by no more than 35 co-owners is not an interest in a business entity under Section 301.7701-2(a) of the Regulations for purposes of qualification of the UFI as eligible replacement property.

a. Conclusions From Ruling

PLR 200513010 suggests that (i) the IRS will not view the multi-tenant aspect of the building as creating a partnership; (ii) a blanket mortgage will not violate the guidelines of Revenue Procedure 2002-22; and (iii) the power of the manager to exercise discretion when leasing, without obtaining the express consent of the owners, will not cause the UFI to fail to constitute eligible replacement property. The Ruling also implies that a sponsor may retain an ownership interest for up to six months without causing the sponsor’s activities in selling the UFIs to the other co-owners to be attributed to those co-owners. Ownership by the sponsor may be important to investors as an indication of the prudent nature of the investment.

2. Overcoming Problem Requiring Unanimity of Tenants

An important condition for obtaining a favorable ruling under Revenue Procedure 2002-22 is that tenants in common each has a right to participate in decisions regarding tenants and management. IMPLIED consent may be used to minimize this problem. A notice can be sent to tenants providing that their consent will be assumed unless they respond within 15 or 30 days. Certain business decisions, such as those involving leases to new tenants, require the approval of all co-owners. However, a prospective tenant might not agree to wait a month for approval by all co-owners. PLR 200513010 suggests that certain business decisions requiring expeditious action may be put to co-owners for their approval within a much shorter period of time without violating Revenue Procedure 2002-22.

3. PLRs 200826005, 200829012 and 200829013

In three recent PLRs, the IRS ruled that two 50% undivided fractional interests in real property did not constitute an interest in a business entity for purposes of qualification as eligible replacement property in a §1031 exchange. The rulings provide flexibility to two-
party 50% tenancy-in-common ownership structures with regard to qualification as eligible replacement property. In approving a two-party 50% undivided interest structure for purposes of qualifying 1031 exchanges, the ruling modified four conditions specified in Rev. Proc. 2002-22:

a. **Buy-Sell Procedure Approved.**

The Agreements required the co-owners to invoke the buy-sell procedure prior to exercising their right to partition the property. Since Rev. Proc. 2002-22 provides that each co-owner must have the right to partition the property, the PLRs construed this requirement with great latitude.

b. **Co-Owner’s Right to Approve Encumbrances**

Although Rev. Proc. 2002-22 provides that each co-owner may encumber their property without the approval of any person, the Agreement in question allowed each co-owner the right to approve encumbrances. The IRS reasoned that since there are only two 50% owners, the restriction on the right of a co-owner to engage in activities that could diminish significantly the value of the other 50% interest without the approval of the other co-owner was consistent with the requirement that each co-owner have the right to approve an arrangement that would create a lien on the property.

c. **Approve Right to Indemnification for Payment of Debt**

The PLRs modified a requirement within Rev. Proc. 2002-22 regarding proportionate payment of debt. While the Rev. Proc. provided that each co-owner must share in any indebtedness secured by a blanket lien in proportion to their own indebtedness, the PLR approved an arrangement whereby an owner who paid more than 50% would have a right to be indemnified by the other co-owner. Therefore, the Agreement provides a mechanism whereby the co-owners could pay an amount which deviates from their proportionate share of debt.

d. **Lease to Affiliated Entity Allowed**
While Rev. Proc. 2002-22 limits co-owners’ activities to those customarily performed in connection with the maintenance and repair of rental real property, the PLRs approved a provision which allows co-owners to lease the property to an affiliated entity. In each PLR, the properties were leased to an affiliate of one of the co-owners who conducts a business unrelated to the management and leasing of the property.

G. Revenue Ruling 2004-86 - Delaware Statutory Trusts

Revenue Ruling 2004-86 expanded the scope of replacement property to include certain interests in grantor trusts which themselves own real property. The ruling equates interests in a Delaware Statutory Trust (DST) that owns real property with actual ownership of real property. Therefore, the exchange of real property for an interest in a Delaware Statutory Trust which itself owns real estate qualifies for exchange treatment. Delaware Statutory Trusts may be owned by any number of persons, although ownership by more than 499 would cause the DST to constitute a security subject to federal securities laws.

1. Delaware Statutory Trust Defined

A Delaware Statutory Trust is an unincorporated association recognized as an entity separate from its owners. The trust may sue or be sued, and property within the trust is subject to attachment or execution as if the trust were a corporation. Beneficial owners of a DST are entitled to the same limitation on personal liability extended to stockholders of a Delaware corporation. DST interests are freely transferable, but are not publicly traded on an established securities market. See Delaware Statutory Trust Act, 12 Del. C. 3801 et. seq. (1988).

2. DST Interests Not Subject to Reclassification as Partnership or Trust

The DST is not a business or commercial trust created by the beneficiaries simply as a device to carry on a profit. Therefore, the DST is not subject to recategorization as a partnership under Regs. § 301.7701-3. Furthermore, the trustee’s activities are limited to the collection and distribution of income. The trustee must distribute all available cash (less reserves) quarterly to each beneficial owner in proportion to that owner’s respective interest in the DST, and may not exchange real estate or purchase assets other than short-term Treasury obligations. The trustee has no power to vary the investment of the certificate holders and may not take advantage of variations in the market to improve the investment. Therefore, the DST is an investment trust for federal income tax purposes, and is not subject to recategorization as a business entity under Regs. § 301.7701-4(c)(1). See Com’r v. North American Bond Trust, 122 F.2d at 546.
3. **Contribution to DST and Exchange**

In the facts of the ruling, sponsor executes a promissory note to purchase Blackacre. The note is secured by Blackacre. Sponsor then enters into a 10-year triple net lease with tenant. Sponsor contributes Blackacre to a newly-formed DST, which assumes sponsor’s rights and obligations under the note and the lease. B and C, owners of Whiteacre and Greenacre, exchange their properties for Sponsor’s entire interest in the DST through a QI. Whiteacre and Greenacre were held for investment by B and C, and are of like kind to Blackacre. The issue posed in the ruling is whether B and C should be accorded exchange treatment.

4. **Grantor Reports Income of Grantor Trust**

Section 677(a) treats the grantor as owner of any portion of a trust whose income, without the approval or consent of any adverse party, is or may be distributed to the grantor or the grantor’s spouse. Section 677(a) also requires the grantor to report items of income and deduction attributable to the trust. Regs. §1.671-2(e)(1) provides that a person who owns an undivided fractional interest in a trust is considered to own the trust assets attributable to that interest. Accordingly, each DST certificate holder is treated as the owner of an undivided fractional interest (UFI) in the DST, and each is considered to own the trust assets attributable to that interest. B and C, who receive DST interests in exchange for real property, are considered grantors of the DST when they acquire these interests in exchange for their real property, and they are considered to own an undivided fractional interest in the real property owned by the DST. See Revenue Ruling 85-13.

5. **Exchange Qualifies Under Section 1031**

In approving exchange treatment, Revenue Ruling 2004-86 concludes:

> Accordingly, the exchange of real property . . . for an interest in a DST through a qualified intermediary is the exchange of real property for an interest in Blackacre, and not the exchange of real property for a certificate of trust or beneficial interest under Section 1031(a)(2)(E). Because [the replacement property] is of like kind to Blackacre, and provided the other requirements of Section 1031 are satisfied, the exchange of real property for an interest in the DST . . . will qualify for nonrecognition of gain or loss under Section 1031.

6. **Distinguished from TICs**

No more than 35 persons may own TIC interests. Since DST ownership is
not so limited, a DST might require a much smaller initial investment than a TIC. A TIC is not a single legal entity, but rather is comprised of many tenants in common. A DST is a single legal entity. While neither a TIC nor a DST may operate as a business, a TIC may borrow money. The activities of a DST are sharply limited. Even a repair to an existing apartment could pose a problem for a DST. While rent receipts could be used to effectuate repairs, trust principal of the DST, could not be used for that purpose. While insurance could be purchased by a DST, the refusal of an insurer to timely pay a claim could cause a severe cash flow problem to the DST. While a DST sponsor could put money into the DST to effectuate repairs, the sponsor could not withdraw the money after the repairs were made. These limitations suggest that a DST might work well for a long term triple net lease with a creditworthy tenant (i.e., Walgreens), but would not be an effective vehicle within which to own and operate multi-tenant commercial property.

XVII. Partnership and LLC Exchange Transactions

A. Exchanges of LLC Interests Barred

The prohibition placed on the exchange of partnership interests by Section 1031(a)(2)(D) in 1984 reflected the concern that the boot gain recognition rules could be avoided by exchanging interests in a partnership which held cash and other nonqualifying property. Since an LLC is treated as a partnership for federal income tax purposes, the exchange of LLC interests would also be excluded from exchange treatment under Section 1031(a)(2)(D). Revenue Rulings 88-76, 93-5, 93-6, 93-30 and 93-49.

B. Distinguish: Exchanges by LLC or Partnership

Although interests in a partnership or LLC may not be exchanged under Section 1031, an LLC or a partnership may itself engage in an exchange in the same manner as would an individual taxpayer. The qualified use requirement is determined at the LLC level, without regard to its members. Gain, if any, would be calculated at the entity level and would be allocated to members according to the operating agreement. Character of gain is generally determinated at the partnership level. Section 702.

1. Deferred Exchanges by Partnerships

The rules governing deferred exchanges by LLCs should be the same as rules governing such exchanges by individual taxpayers. Since the Regulations do not state who must sign the Notice of Identification of Replacement Property, prudence would dictate that the notice be signed by all of the members, or at least all of the managing members.

C. Problem of Liabilities and Section 752

Section 752(a) provides that any increase in a partner’s share of partnership liabilities shall
be treated as a contribution of money by the partner. Conversely, Section 752(b) provides that any
decrease in a partner’s share of partnership liabilities shall be considered as a distribution of money
to the partner. Section 733 provides that the adjusted basis of the partnership interest is reduced, but
not below zero, by the amount of money distributed to the partner by the partnership. Regs. § 1.752-
1(f) provides that if, as a result of a single transaction, if a partner incurs both an increase in the
partner’s share of partnership liabilities and a decrease in a partner’s share of partnership liabilities,
only the net decrease is treated as a distribution from the partnership and only the net increase is
treated as a contribution of money to the partnership. When a partnership relinquishes property
subject to a liability and is relieved of those liabilities, a decrease in the partner’s share of
partnership liabilities occurs. Under Section 1031(d) and Regs. § 1.1031(b)-1(c), the assumption
of a taxpayer’s liabilities is taxed to him as boot. If a partnership relinquishes property subject to
a liability in the first leg of a deferred exchange, is the later acquisition of replacement property also
subject to a liability considered part of a single transaction for purposes of the Regulations under
Section 752?

1. **Revenue Ruling 2003-56**

Revenue Ruling 2003-56 appears to resolve this issue. The ruling states that
if the partnership enters into a deferred exchange in which the relinquished property
subject to a liability is conveyed in year one, and replacement property subject to a
liability is acquired in year two, the liabilities are netted for purposes of the Section
752 rules. The ruling states that if the relinquished property has liabilities in excess
of the replacement property’s liabilities, the gain is taxed in year one.

D. **At-Risk Issue Involving LLCs**

Section 465, enacted in 1976, allows taxpayers to deduct losses from an activity only to the
extent the taxpayer is “at risk” with respect to that activity at the end of the taxable year. The at-risk
limitations were enacted to prevent taxpayers from deducting losses generated by activities where
those losses exceeded the taxpayer’s actual investment risk. The at-risk rules are applied at the
member level. Although the activity of holding real property was originally exempt from the at-risk
rules, the exception was repealed by the Tax Reform Act of 1986. Section 465(e) provides that if,
as a result of a like kind exchange, the member’s at-risk amount falls below zero, this negative
amount at risk is recaptured as ordinary income.

1. **Aggregation of Activities**

Section 465(a) provides that the at-risk rules are computed separately with
respect to each “activity” carried on by the taxpayer. This is disadvantageous, since
it lowers the amount considered at-risk and causes more ordinary income recapture.
However, replacement property might qualify for “aggregation” under Section
465(c)(3)(B) into a single activity. To qualify for aggregation, the activity must (i)
constitute a trade or business of the member; and the member must (ii) either
“actively participate” in that trade or business, or 65 percent or more of the losses for
the taxable year must be allocable to persons who “actively participate” in the
management of the trade or business. Section 465(c)(3)(C) provides that aggregation
of activities is also permissible as provided in the Regulations. To date, no such Regulations have been promulgated.

E. Passive Loss Issues Involving LLCs

Section 469, enacted in 1987, prevents taxpayers from reducing or eliminating income tax liability by offsetting against taxable income current losses and deductions generated from “passive activities,” i.e., activities in which the taxpayer does not materially participate and all rental activity. Losses suspended under the passive loss rules will not be triggered if the taxpayer engages in a Section 1031 exchange, since less than all of the realized gain is recognized.

F. Direct-Deeding to Members Following LLC Exchange

Would the requirements of the deferred exchange rules be satisfied if the LLC directed the QI to transfer title in the replacement property directly to LLC members following an exchange by the LLC? Under the “aggregate” theory, the LLC is ignored for purposes of computing federal income tax. However, the LLC is not ignored for purposes of satisfying the like kind exchange requirement. Regs. §1.1002-1(d) comprehend an “exchange” for purposes of Section 1031 as being a reciprocal transfer of property, as distinguished from a transfer of property for a money consideration only. Since the LLC itself must meet the qualified use test, a transaction in which the LLC never held title to the replacement property would probably not qualify under Section 1031.

G. Distributing Interests Followed by Exchange “Drop and Swap”

One partner may wish to cash out, while the other partners may wish to engage in a like-kind exchange. This could be accomplished by distributing an undivided interest in partnership property to the partner wishing to cash out. The partnership would recognize no gain on the distribution under IRC § 731(b). The distributee partner would also recognize no gain on the distribution and would take a basis in the distributed interest equal to his basis in the partnership interest under IRC Sections 731(a)(1) and 732(b). Would a distribution of tenancy in common interest to one partner, followed by the partnership’s exchange qualify for like-kind treatment? The IRS could assert either that the qualified use requirement was violated or that the “exchange” consisted of an exchange by a tax partnership of partnership interests – rather than an exchange by co-owners of TIC interests.

1. Possible IRS Objections

   a. Qualified Use Objection

   In Mason v. Com’r, T.C. Memo 1988-273, a transaction between former partners following a partnership dissolution was held to be an exchange of assets held individually rather than an exchange of partnership assets. However, Mason is of questionable precedential value since the Tax Court failed to consider whether the qualified use requirement had been satisfied. Revenue Ruling 77-337 denied exchange treatment where a liquidating corporation
distributed property to a shareholder who then sought to engage in a like kind exchange. The corporation’s qualified use could not be imputed to the shareholders. However, in the case of distributions by partnerships or LLCs followed by an exchange at the partner level, the qualified use test may be less difficult to satisfy, since for federal income tax purposes the partnership may viewed as an “aggregate” of its partners.

b. **Objection Based on Rev. Proc. 2002-22**

The distribution of TIC interests under state law may be treated by the IRS as the distribution of a partnership interest if, after the exchange, the entity is not engaged in completely passive activities. Revenue Procedure 2002-22, which sets forth the conditions for a ruling that a co-ownership is not a tax partnership, sheds some light on this issue. Revenue Procedure 2002-22 states that no ruling will be issued if the co-owners held interests in the property through a partnership or corporation immediately prior to the formation of the co-ownership. However, the fact that no ruling will be issued is not dispositive, since the ruling by its own terms is inapplicable to audits.

c. **Additional Considerations**

Additional transfer taxes will be generated by the distribution of tenancy in common interests. Following the distribution, ownership will change and new title policies will be required for closing. If the contract of sale for the relinquished property has been assigned to a QI before distribution of TIC interest, the IRS could invoke step transaction doctrine. Therefore, the transaction should be planned before contract negotiations for the sale of the relinquished property commence.

2. **Cashing Out One Partner**

Must all partners in a “drop and swap” exchange into new replacement property? Or, can one partner who wants cash sell his TIC interest and pay capital gains tax, while the other while the other partners swap their tenancy-in-commons interests and acquire either a single replacement property or separate replacement properties? All of the above concerns raised where the partners acquire separate placement properties would also apply here. In addition, the receipt of cash seems to make the transaction more vulnerable under the step transaction doctrine enunciated by the Supreme Court in *Court Holding Company v. Com’r*, 45-1 USTC ¶9215, 324 U.S. 331, 65 S.Ct. 707 (1945) unless the transaction was planned well in advance of the exchange.
3. **Advance Planning Imperative**

Although time is not a luxury that partners wishing to dispose of partnership property can often afford, advance planning would greatly increase the probability of success in cashing out one partner. To illustrate, following the distribution to Partner A of an undivided partnership interest, that partner could lease the interest back to the partnership under a long-term triple net lease. Under the terms of that lease, Partner A would retain the right to partition the property and to dispose separately of his interest. Following the passage of at least one tax year, the partnership could begin active negotiations to sell the property. Partner A would sell, and the partnership would exchange, their respective interests to buyer. The long term lease would expire under the “merger” theory.

H. **External Buy-Out**

May some partners, either before or after the exchange, buy out other partners who wish to receive cash? In the case of a pre-exchange buy out, the non-exchanging partners will receive cash before the closing, an advantage that may encourage those partners to cooperate with those partners who would like the partnership to engage in an exchange. A post-exchange buy out may also be structured. However, the partners wishing to be cashed out may not agree to wait until after the exchange to receive cash. Whether the buyout is pre- or post-exchange, additional cash will be required to acquire the partnership interests of the non-exchanging partners.

1. **Advantages of External Buy-Out**

The most attractive feature of the external buy-out is its very low tax risk when properly structured. No qualified use issue appears to exist, since the partnership exchanges property which it has held for the required purpose and acquires property which it continues to hold for the requisite purpose. Since the buyout is external, one would argue that the partnership has not been affected for purposes of Section 1031. An external buyout works best where the partner sought to be bought out has a small interest and the partnership property itself has little debt. If a large mortgage exists on the property to be relinquished, the partnership may have to borrow large amounts of funds to exchange into property of equal value.

2. **Disadvantages of External Buy-Out**

As noted, the partners must provide cash to accomplish the buy out. Assume four partners have equal interests in partnership. One partner wants cash. Although the exchanging partners must find cash to buy out the interest of the partner cashing out, the partnership will still be required to exchange into property of equal value. In contrast, if the non-exchanging partner were redeemed out in exchange for a tenancy in common interest, the partnership would only be required to exchange into the value of partnership property remaining after the distribution of the TIC interest. If partnership property has a large amount of debt, the partnership would be required
to exchange into highly leveraged property. Finally, if a partner or partners whose interests equal 50 percent or more are to be bought out, a partnership termination must be avoided.

a. Post-Exchange Financing

In an external buyout, the partnership will be required to exchange into property whose value is unreduced by any amounts paid for the cashing out partner’s partnership interests. This is because the cashing out partner’s interests is being purchased by a partner, rather than redeemed by the partnership. This disadvantage can be lessened if the partnership mortgages the newly acquired replacement property to pay off any bridge loans incurred for the buyout. Those post-exchanged loans, secured by the replacement property, may be at a substantially lower interest rate than the pre-exchange loans incurred by the partners to buy out the other partners’ interests.

(1) Financing Should be Independent

Partners may want to repay higher interest pre-exchange bridge loans quickly following the exchange by obtaining a new loan on the replacement property. The two loans should not be tied together or made interdependent. Since the partners whose interests are being bought out would probably reject their sale being affected by the partnership not closing on the replacement property, as a practice matter this concern may be moot. In addition, the pre-exchange bridge loan should not be collateralized by the relinquished property. The risk incurred by the exchanging partners in obtaining a bridge loan to accomplish the buyout, and the attendant possibility that the partnership might not close on the relinquished property, while posing a definite economic risk, is precisely what minimizes the tax risks in structuring the transaction in this manner.

3. Partnership Election Under Section 754

Since the external buyout does not involve the purchase of partnership assets directly, the inside basis of partnership assets will remain unchanged following the buyout. A partnership may elect under Section 754 to adjust the basis of partnership property in the case of (i) a distribution of partnership property, as provided for in
Section 734 and in the case of (ii) a transfer of a partnership interest, as provided for in Section 743. By making this election, the inside basis of the partnership interests purchased in the buyout can be increased to fair market value. This will be beneficial to the remaining partners when the partnership ultimately disposes of the replacement property, or when depreciation deductions are calculated for the replacement property.

a. **Transfer of Partnership Interest**

Section 743 provides that where a partnership interests is sold or exchanged, the partnership shall (i) increase the adjusted basis of the partnership property by the excess of the basis to the transferee partner of his interest in the partnership over his proportionate share of the adjusted basis of the partnership property and (ii) decrease the adjusted basis of the partnership property by the excess of the transferee partner’s proportionate share of the adjusted basis of the partnership property over the basis of his interest in the partnership.

I. **Elect Out of Subchapter K**

An election under Section 761(a) to be excluded from Subchapter K has some facial appeal. However, Regs. § 1.761-2(a)(2) requires that the members of such an organization own the property as co-owners and not actively conduct business. The regulations provide that an investment partnership will exist where partners (i) own property as co-owners; (ii) reserve the right separately to take or dispose of their shares of any property acquired or retained; or (iii) do not actively conduct business. This requirement would appear to limit the utility of a Section 761(a) election to facilitate the exchange of partnership interests of partnerships owning real estate.

J. **Exchange Followed by Distribution “Swap and Drop”**

1. **Distribution of Replacement Properties to Partners**

Suppose an LLC designates three separate replacement properties which, after being acquired by the LLC, are then distributed to three LLC members. Is this a good Section 1031 exchange? Since the LLC has transferred the relinquished property and acquired the replacement property, the only objection could seemingly be one based on qualified use. The IRS could argue that the LLC did not acquire

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25 Section 734 provides that where partnership property is distributed and a Section 754 election is in effect, the adjusted basis of partnership property is increased by the amount of gain recognized to the distributee partner and decreased by the amount of loss recognized to the distributee partner.

26 Regs. § 1.761-2(a)(2).
replacement properties for the purpose of holding it for productive use in a trade or business or for investment, as required under Section 1031(a)(1), but rather for the purpose of distributing it to its members. However, *Maloney v. Com’r*, 93 T.C. 89 (1989) held that an exchange by a corporation followed by a distribution of the replacement property did satisfy Section 1031(a)(1).

2. **Cashing Out Using Installment Method**

   a. **Relinquished Property Exchanged for Cash and Note**

      The use of a purchaser’s installment note can effectuate the cashing out of one partner while allowing the partnership to engage in an exchange. At closing, the cash buyer pays for the relinquished property with a mix of cash and an installment note. The cash is transferred to a QI and a garden variety deferred exchange ensues with respect to that money. The installment note is transferred directly to the partnership in a taxable sale. Under the installment sale rules of Section 453, the receipt by the partnership of the purchaser’s installment note is not considered “payment”. Therefore, no gain will be recognized by the partnership upon receipt of the note.

   b. **Partnership Distributes Installment Note**

      The partnership would then distribute the installment note to the partner wishing to cash out. The distribution of the note (i) is tax-free under Section 731 because it is not “money” and (ii) will not constitute a “disposition” under Section 453B. See Regs. § 1.453-9(c)(2); PLR 8824044. Typically, 97 percent of the installment note would be payable a week after the redemption. The remaining 3 percent would be payable in the beginning of the following taxable year. Since payments would be made over two years, installment method reporting under Section 453 should be available. If the partner cashing out will not accept the purchaser’s own installment note, the obligation can be secured by the obligation could be secured by a nonnegotiable commercial standby letter of credit without resulting in the receipt of the note by the partnership to be considered “payment.”

   c. **Example Using Installment Note Method**

      ABC partnership is owned equally by three partners, A, B, and C. ABC partnership owns property in Manhattan worth $9 million and that has a basis to the partnership of $6 million. Each partner’s basis (and capital account) in ABC is $2 million. A and B
wish to engage in a tax free exchange, and C wants to cash out. The cash buyer of the Manhattan property pays $6 million in cash to a qualified intermediary, who uses that money to purchase replacement property. In exchange for $6 million in cash, the QI directs the partnership to direct-deed its undivided two-thirds interest in the property described in the exchange agreement directly to the buyer. The remaining $3 million is paid to ABC Partnership in the form of a promissory note, 97 percent of which is payable a week following the closing, and one percent on January 1st of the following year. If the note qualifies as an installment obligation, boot gain will be shifted from the partnership to C. In exchange for this note, the partnership itself conveys the remaining one-third undivided interest in the property to the buyer. The partnership books up its assets so that C’s capital account is increased to $3 million, representing the increased value of his interest in the partnership’s assets. At closing, the partnership distributes the $3 million note to C in redemption of his entire partnership interest. Upon receipt of the promissory note, C will have a tax basis in the note equal to the tax basis he previously had in his partnership interest, or $2 million. C will recognize gain on each payment made under the installment note using the installment method as provided in IRC § 453(c).

C’s basis in his capital account balance after the distribution will be $0, i.e., his original basis in his capital account balance in ABC of $2 million, increased by $1 million for the book up, and decreased by $3 million for the distribution of the promissory note. Since there is no special allocation of recognized gain, and since C’s capital account is zeroed out, the transaction appears to meet all Section 704(b) requirements. The distribution of the note must take place before any payments are made on the note; otherwise, the

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27 Regs. § 1.1031(k)-1(g)(4)(iv)(B). This will avoid the imposition of one real property transfer tax.

28 To qualify as an installment obligation, at least one payment must be due after the last day of the partnership’s tax year in which the closing took place. IRC § 453(b)(1).

29 IRC § 732(b).

30 Gain would be treated as gain from the sale or exchange of a capital asset under IRC § 741, unless the partnership held “unrealized receivables” or “inventory properties,” in which case a portion of the gain would be treated as ordinary income under IRC § 751.
partnership will violate the special allocation rules.31

d. **Obtaining Letters of Credit**

Typically, a commercial bank will readily issue a letter of credit provided the cash buyer deposits an equal sum with the bank. The cash buyer, who will have previously arranged for financing to purchase the replacement property, is not likely to object to obtaining a letter of credit, although the administrative requirements since 2001 have increased somewhat. The letter of credit should be arranged well in advance of closing. The partner receiving the promissory note must also be willing to forego the receipt of interest for a short period of time.

e. **Variation Involving Redemption**

A variation of the above method involves the partnership redeeming the partner’s interest in exchange for the partnership’s own installment note. Following the redemption, the partnership pursues a typical like kind exchange. Shortly after the acquisition of replacement property, the partnership engages in post-exchange financing and pays off the installment note held by the partner who was redeemed out over two taxable years, in the same manner as described above, in where the purchaser provided the installment note.

3. **Advantages of Installment Note Method**

The installment note method has the following advantages: (i) no gain is recognized by the partnership upon receipt of the installment note of the purchaser; (ii) the distribution of the installment note to the partner cashing out should not result in gain recognition under Sections 453 and 731; and (iii) the exchange appears to meet the qualified use requirement since the partnership has (presumably) held the relinquished property for business or investment and will hold the replacement property for business or investment. However, despite the allure of the installment note method, there are numerous exceptions to nonrecognition under Section 453 whose potential application should be analyzed. Another problem is that the partnership must avoid a termination under Section 708(b).

a. **Definition of Partnership Termination**

31 However, under IRC § 453(i), any part of the gain subject to depreciation recapture under IRC § 1245 or IRC § 1250 would be ineligible for deferral under the installment note, and would be recognized immediately.
Section 708(a) provides that a partnership is terminated if no part of any business continues to be carried on by any of its partners or if, within a 12 month period, there is a sale or exchange of 50 percent or more of the total interest in partnership capital and profits.

b. ABA Position

The ABA takes the position that the transfer of property to or from a partnership before or after a like kind exchange should not violate the qualified use requirement, since the proper standard for that requirement should be the absence of taxpayer intent to liquidate an investment in the subject property (i.e., intent to sell the property or give it as a gift) or acquire the property for personal use.

K. May Partners Make Special Allocations of Gain?

When property ownership is through a tenancy-in-common rather than through a partnership, it appears that some co-tenants may exchange their interests in a like kind exchange, and others may sell their interests and receive cash. In that case, only the co-tenants receiving cash would presumably recognize taxable gain. Query whether the same tax result could be possible if the property is owned by a partnership? That is, may partners specially allocate gain recognized in the exchange to a partner who is not participating in the exchange, and whose interest in the partnership is about to be liquidated?

1. View of Regulations

According to Section 704(b) and Regulations thereunder, an allocation of taxable income or loss agreed upon by the partners is permitted if the allocation meets one of the following tests: (i) the allocation has a “substantial economic effect”; (ii) the allocation is in accordance with the partners’interests in the partnership; or (iii) the allocation is in accordance with IRC § 704(c).

2. Economic Effect

Generally, an allocation has “economic effect” if the partnership maintains its capital accounts in accordance with the Regulations, and upon dissolution, each partner receives the amounts remaining in his capital account. In such cases, the

32 IRC §704(b) and Regs. §1.704-1(b)(2).

33 IRC §704(b) and Regs. §1.704-1(b)(3).

34 See Regs. §1.704-1(b)(2)(iv)(f) and Regs. §1.704-3(a)(6).
allocation will be consistent with the underlying economic arrangement between the partners. In general, if a partner has a capital account deficit following dissolution, he must be required to restore that deficit. This means that the allocation must result in the appropriate increase or decrease in the partner’s capital account, and partners must be required to make up negative balances in their capital accounts upon the liquidation of the partnership. Reg. § 1.704-1(b)(2)(ii)(a). Stated another way, when a tax benefit or tax burden is allocated to a partner, that partner must also receive a corresponding economic benefit or burden.

a. Substantial Economic Effect

It is not enough that an allocation have economic effect. The economic effect of the allocation must also be substantial. The economic effect of an allocation is “substantial” if there is a reasonable possibility that the allocation will affect substantially the dollar amounts to be received by the partners from the partnership, independent of tax consequences. Regs. § 1.704-1(b)(2)(h)(iii)(a).

3. Partners’ Interests in the Partnership

Often, partnership allocations are made in accordance with the partners’ interest in the partnership. A special allocation might have substantial economic effect if the partner had a zero capital account balance following the special allocation. However, if a partner’s pre-transaction capital account is 10x dollars and that partner is allocated 5x dollars of gain, the partner’s capital account will be 15x dollars following the closing. Even if all of the 5x dollars is distributed to the retiring partner, his capital account would be reduced, but only to 10x dollars. If the partner is left with a positive capital account balance following an exchange, it might be difficult to take the position that the tax allocation corresponds substantially affects the dollars amounts to be received by the non-retiring partners.

4. Allocation In Accordance with Principles of Section 704(c)

Section 704(c) applies rules to partnership properties that have book values that are different from the properties’ adjusted tax bases. However, seldom would a “book/tax” disparity exist which could cause the application of Section 704(c) in this circumstance.

5. View of ABA
The ABA Section of Taxation views a special allocation of gain in this circumstance as possessing substantial economic effect since there appears to be a reasonable possibility that the allocation will affect substantially the dollar amounts to be received by the partners from the partnership, independent of tax consequences. This conclusion is based on the assumption that the retiring partner will not participate in the future economic profits or losses attributable to the replacement property, and the remaining partners will benefit from potential profits and will also bear all of the risks associated with the replacement property. Therefore, the special allocation of gain will affect the dollar amounts received by the retiring partner.
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