

# Like Kind Exchanges of Real Estate Under IRC §1031

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## I. Introduction<sup>3</sup>

### 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,

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<sup>3</sup> Circular 330 disclosure: Any tax advice herein is not intended or written to be used, and cannot be used by any taxpayer, for the purpose of avoiding any penalties that may be imposed under the Internal Revenue Code.

escaped rigorous Congressional scrutiny.<sup>4</sup> 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.<sup>5</sup>

## **B. Overview of Statute**

Section 1031(a)(1) provides the general rule of nonrecognition of gain or loss if property held for productive use in a trade or business is exchanged for property of “like kind” which is also held for productive use in a trade or business or for investment. Section 1031(a)(2) excepts exchanges of six types of property from like kind exchange treatment. Section 1031(a)(3) provides relevant time periods for deferred exchanges. Section 1031(b) provides that the receipt of property not qualifying for exchange treatment (in an otherwise qualifying exchange) will not disqualify the like kind exchange. However, the receipt of such nonqualifying property, or “boot” will result in realized gain being recognized to the extent of such boot. Section 1031(c) provides that realized loss with respect to exchange property will not be recognized even if nonqualifying property (“boot”) is received in the

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<sup>4</sup> 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, provided the transaction is not “structured to avoid the purposes of [Section 1031].

<sup>5</sup> 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.

exchange.<sup>6</sup> Section 1031(d) provides rules for determining the basis of qualifying property and boot received in an exchange; Section 1031(d) also provides that if, as part of the consideration, another party to the transaction assumes a liability of the taxpayer, that assumption will be treated as money received by the taxpayer (*i.e.*, boot). Section 1031(f) provides rules articulating limitations and restrictions on exchanges between related parties.

### 1. Terminology

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 (9<sup>th</sup> 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) or property expressly excluded from exchange treatment under

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<sup>6</sup> However, if as part of the consideration for qualifying property received in the exchange, the taxpayer transfers nonqualifying property (such as publicly traded stock with a built in loss) in addition to qualifying exchange property, such loss may be recognized.

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.)

## **C. 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 estimated that like kind exchange transactions would 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 (9<sup>th</sup> Cir. 1985). (Taxpayer cannot convert business property to personal use property and claim exchange treatment.) The Tax Court also denied like kind exchange treatment for a vacation home used by the taxpayer but never rented. *Barry E. Moore, T.C. Memo, 2007-134*. *Moore* held 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 wait until January 1<sup>st</sup>, 2011 – five years from the January 1<sup>st</sup>, 2006 like kind exchange – before claiming the residence exclusion with respect to the Florida condo.*

**D. 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. Primary Purpose Determinative**

CCA 201025049 interpreted the phrase “stock in trade or property held primarily for sale”. If an asset can function both as merchandise held for sale and as an asset used in a trade or business, the taxpayer’s *primary purpose* for holding the asset determines whether that asset is stock in trade. Temporarily withdrawing an asset from inventory for business use is not sufficient to imbue the property with the attribute of being held for use in the ordinary course of business operations. The advisory concluded that (i) since the corporation did not possess a “general or indefinite commitment” to use the equipment in its trade or business, the property is not depreciable under IRC § 167 and (ii) since the corporation held the equipment primarily for sale and the exchange will not qualify under IRC § 1031.

**b. Dealers in Real Estate**

Real estate dealers cannot exchange real

property held as inventory, since such property would not have been held for the 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.

(1) ***Baker Enterprises v. Com’r.***

*Baker Enterprises v. Com’r.* held that property was held “primarily for sale” by a real estate dealer even though it was not held as dealer property. Critical in the Court’s decision was its finding that the taxpayer classified the property as a “work in progress” rather than an investment, in its books. T.C. Memo, 1998-302.

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.” 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 percent partnership interest as replacement property for the taxpayer’s exchange where the taxpayer owns the other 50 percent. The partnership’s only asset is comprised of 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.

**E. 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.

**F. 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 by distributing the real property to the partner as a tenancy-in-common interest before death, thereby ensuring a stepped-up basis.

**G. 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 8.97 percent<sup>7</sup> tax on taxable income, without distinction for capital gains. Thus, the combined federal and state rate on long term capital gains (assuming no

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<sup>7</sup> In 2010, New York added two new income tax rate brackets of 7.85 percent for income over \$200,000 and 8.97 percent for income over \$500,000.

unrecaptured Section 1250 gain) is 23.97 percent, and 27.62 percent for NYC residents (or NYC property). If depreciable real estate is involved, the combined federal and state rates on long term capital gains climbs to 28.97 percent, and 32.62 percent for NYC residents. A Manhattan resident exchanging a zero basis vacant lot<sup>8</sup> 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 43.97 percent and 47.62 percent for NYC residents.<sup>9</sup>

#### **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 37.63 percent, consisting of (i) a federal tax of 25 percent; (ii) a New York tax of 8.97 percent; and

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<sup>8</sup> The lot could have a zero basis if it had been previously acquired in a like kind exchange.

<sup>9</sup> In *Montes v. Asher*, 182 F. Supp. 2d 637 (N.D.O. 2002), a taxpayer selling his restaurant mentioned to his CPA that he was considering acquiring a new restaurant. The CPA failed to articulate the benefits of a Section 1031 exchange. After selling his restaurant and recognizing gain, Montes filed a malpractice suit against the accountant. The Northern District of Ohio issued summary judgment in favor of Montes.

(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 under Section 1245, the combined federal and state tax rate would be higher.

**2. 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 the deed is filed with the county clerk. If the deed and accompanying documents are not in proper order, the record clerk will not accept them. In a situation involving an Exchange Accommodation Titleholder (EAT) in a reverse exchange, the taxpayer may claim 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, it will be the county clerk – and not the courts or the IRS – who will decide whether the EAT is actually only acquiring “bare” legal title. If the clerk believes that more than bare legal title is being acquired by the EAT, the clerk will refuse to record the deed.

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

In some circumstances it will be necessary to “cash out” a partner receiving cash, rather than participating in a deferred exchange. Some transfers of partnership interests not involving a “controlling” interest will not be subject to real estate transfer taxes. However, the transfer of a “controlling” interest in a partnership or LLC will be subject to transfer tax in New York (as well as Connecticut, Pennsylvania, and South Carolina). Two transfer taxes will normally be generated in a like kind exchange: Transfer tax imposed on the sale of the relinquished property; and the transfer tax incurred in connection with the sale of the replacement property.

However, if a partner is also being cashed out, a third transfer tax could also be incurred. In addition, if the replacement property is acquired by a disregarded single member LLC (as would likely be the case with an EAT) a fourth transfer tax could 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 by New York 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.

**4. 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 nevertheless be reported. One such exempt transfer that may be relevant in like kind exchanges includes transfers from a principal to his agent, or from an agent to his principal. In a “reverse” exchange, an Exchange Accommodation Titleholder (EAT) acquires bare legal title to the deed. The transfer of replacement property to the EAT could qualify for the “mere change in form or identity” exemption. In a typical deferred exchange the Qualified Intermediary (QI) is not required to acquire even bare legal title. Therefore, by definition, no transfer tax could be imposed. As will be seen, the deferred exchange regulations impose a legal

fiction in which the QI is deemed to acquire title for purposes of the exchange, even though the relinquished and replacement properties are direct-deeded by the taxpayer, and the QI never acquires record title.

#### **5. 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.

#### **6. 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.

## **H. 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).

## **I. Importance of Obtaining Expert Advice When Structuring Exchange**

The Appellate Division, Second Department, affirmed an order granting summary judgment to a defendant attorney sued for malpractice for failing to recognize that cash paid to the taxpayer at closing would take the transaction out of Section 1031. The attorney had cautioned the taxpayer that he did not possess the “requisite knowledge” to handle a like kind exchange and, according to his testimony, he relied on the plaintiff’s representation that the like kind exchange was being handled by his accountant. In the end, the check for the property purchase was paid to the plaintiff, and the exchange failed. The Appellate Division found that the order dismissing the malpractice complaint was correct, since the plaintiff had failed to “satisfy the other requirements” of an exchange. *Wo Yee Hing Realty Corp. v. Stern*, 2012 NY Slip Op 05792. The lone dissent argued that the opportunity for a like kind exchange was “irretrievably lost once plaintiff received the proceeds of the sale,” and that “there was no 1031 exchange, and the 45-day identification period and the 180-day exchange period were never triggered, because of plaintiff’s actual receipt of the proceeds of the sale.”

The Appellate Division appears to have reached the right result for the wrong reason. According to the majority opinion, the plaintiff would have been required to enter into meaningless transactions in order to establish the attorney’s negligence. There appears to be no question that the attorney’s failure to ensure that the plaintiff did not receive the funds was the “proximate cause” of there being no 1031 exchange. However, the attorney had warned the plaintiff that he “did not have the requisite experience to handle the [1031] aspect of the transaction.” Based upon this testimony, the plaintiff then had an obligation to find an attorney or to

obtain appropriate advice concerning the 1031 exchange. The proximate cause issue should never have been reached.

## **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 purchased 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 that under the deferred exchange rules, a taxpayer today could likely 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**

Congress used a broad brush when drafting Section 1031. 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. With the notable exception of its refusal to acquiesce to view expressed by the Ninth Circuit in *Starker v. U.S.*, 602 F.2d 1341 (1979) that exchanges need not be simultaneous (which refusal led to the enactment of the deferred exchange statute in 1984, and later the deferred exchange regulations), the IRS has generally been reasonable in its interpretation of the statute.

## **B. Federal Reporting Requirements**

Proper reporting of 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. The IRS now requests 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 (“Capital Gains and Losses”) or on Form 4797 (“Sales of Business Property”).

### **1. Form 8824 Requires Related Party Information**

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**

Whether an exchange qualifies under Section 1031 is may not always be evident. If “substantial authority” exists for a position taken on a return, the taxpayer will not be subject to accuracy-related penalties for under reporting under IRC §6662, even if the IRS successfully challenges the position taken. Substantial authority exists if the weight of authorities supporting the treatment is substantial in relation to the weight of authorities supporting contrary treatment. 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.

#### **1. Tax Opinion Letters**

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. On the other hand, some transactions, although generating clear and favorable conclusions from a tax standpoint, will not have substantial authority, perhaps because IRS never issued guidance. Those transactions would presumably not require disclosure.

#### **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 guidance concerning the imposition of return preparer penalties. It provides that until the revised regs 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 penalty provisions unless they willfully understate tax or act in reckless or intentional disregard of the law. Revised IRC §6694 joins Circular 230 (which Roy M. Adams observed effectively “deputizes” attorneys, accountants, financial planners, trust professionals and insurance professionals” and “extends the government’s reach and helps 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<sup>10</sup>, Congress has signified its intention to hold tax advisors to a higher standard when rendering tax advice.

**2. Notice 2009-5 Continues Provisions in Notice 2008-13**

Notice 2009-5 provides that tax return preparers may apply

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<sup>10</sup> Judge Learned Hand remarked: “Anyone may arrange his affairs so that his taxes shall be as low as possible; he is not bound to choose that pattern which best pays the treasury. There is not even a patriotic duty to increase one’s taxes.” *Gregory v. Helvering*, 69 F.2d 809, 810 (2d Cir. 1934), *aff’d*, 293 U.S. 465, 55 S.Ct. 266, 79 L.Ed. 596 (1935).

the substantial authority standard in the 2008 Tax Act, or may continue to rely on Notice 2008-13, which provides interim guidance.

**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 (individuals, trusts or estates), who are subject to a 7.7 percent withholding tax.<sup>11</sup> 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. The deed may not be recorded unless the estimated tax is paid or the taxpayer obtains a certification from the NYS Department of Taxation and Finance that no tax is due. 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” 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

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<sup>11</sup> California, Maryland, New Jersey, South Carolina, Rhode Island and Vermont also impose a withholding tax on sales by nonresidents.

initial deferred gain.<sup>12</sup> 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. **California Senate Bill No. 1316**

On April 22, 2010, the California Legislature introduced Bill 1316 which would treat Section 1031 exchanges as taxable transactions. A later amendment to the bill would have required as a condition to tax deferral the requirement that replacement property be located in California. The bill is now “inactive”.

#### 2. **Illustration**

New York resident exchanges low basis Manhattan property for a tenancy 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

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<sup>12</sup> Interestingly, there is no California statute providing for this result. The rule is found in California Franchise Tax Board (FTB) publication 1100.

from either state.<sup>13</sup> 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.

#### **G. Oregon Imposes Statutory Rule**

Oregon has imposed by statute a "clawback" rule similar to that imposed by California. Oregon requires a continuing information return to be filed by nonresidents. Oregon recognizes exchanges of property located in Oregon for property located in another state provided the exchanger is an Oregon resident. Non-Oregon residents who exchange Oregon property for out-of-state property must pay Oregon tax. Massachusetts imposes a clawback rule by regulation, as does Montana. To date, New York has not sought to impose a clawback rule, although New York is said to be unhappy where New York property is exchanged for property in a state with no income tax, where the property is subsequently sold.

#### **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

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<sup>13</sup> 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.

exchange may indeed have occurred. *See Century Electric Co. v. Com'r*, 192 F.2d 155 (8<sup>th</sup> Cir. 1951).

### **I. Requirement That Taxpayer Be the Same**

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 F.2d 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 FOR 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 phrase “held for” 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. Some have suggested that, at a minimum, the property should be held for a period comprising at least part of two separate taxable years (*e.g.*, November, 2010 through October, 2011). However, it should be taxpayer’s intent that is actually determinative. Therefore, an exchange of property held for productive use in a trade or business should qualify even if it were held for less than two years provided the taxpayer’s intent when acquiring the property was to hold the property for productive use in a trade or business or for investment, (rather than to hold it just long enough to qualify for exchange treatment). Of course, evidencing the taxpayer’s intent for a short period of time might be difficult, and for this reason guidelines, such as that articulated in PLR 8429039 are useful.

**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 be 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).

#### 4. **Using Replacement Property as Personal Residence Negates Exchange**

Finding that the “use of property solely as a personal residence is antithetical to its being held for investment,” the Tax Court, citing objective factors indicating that the taxpayer had little if any actual intention to hold replacement property for productive use in a trade or business or for investment, but rather intended to live in the property, denied exchange treatment. *Goolsby v. CIR*, T.C. Memo 2010-64. The taxpayer’s attempt to rent the replacement property was “minimal” and amounted to nothing more than an advertisement in a local newspaper for a few months. The taxpayer moved into the acquired property “within 2 months after they acquired it,” and prior to the exchange discussed with the QI the feasibility of moving into the property if renters could not be found. Moreover, the taxpayer “failed to research rental opportunities” in Pebble Beach and “failed to research whether the covenants of the homeowners association would allow for the rental of the Pebble Beach property.” The Tax Court also upheld accuracy-related penalties imposed by the IRS pursuant to IRC § 6662.

#### 5. **Goolsby Distinguished in Reesink v. Com’r.**

In *Reesink v. Com’r*, T.C. Memo 2012-118, the Tax Court found that the requisite investment intent was satisfied, and ruled for the taxpayer. Here, the taxpayer had tried unsuccessfully for eight months to rent the replacement property. Owing to evidence of financial hardship, which the Tax Court found to be credible, the taxpayer sold its residence in San Francisco and moved into the replacement property. Another factor which distinguished the case from *Goolsby* was that unlike *Goolsby*, the taxpayer had not made the purchase of the replacement property contingent on the sale of their personal residence.

**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 property in a liquidating distribution from his wholly owned corporation and then immediately engaged in an exchange.

**1. *Bolker v. Com'r.* Upholds Exchange Treatment**

The Ninth Circuit in *Bolker v. Com'r.*, 81 T.C. 782 (1983), *aff'd*, 760 F.2d 1039 (9<sup>th</sup> Cir. 1985), in circumstances similar to those in Rev. Rul. 77-337, 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.

**2. *Maloney v. Com'r.* Finds Qualified Use Not Violated**

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.

**3. PLR 200521002 Distinguishes Distribution From Exchange**

In PLR 200521002, the IRS issued a favorable ruling where a trust entered into an exchange with the intention of terminating and distributing the replacement property to trust beneficiaries. The "held for" requirement was satisfied since the IRS viewed the

distribution and exchange as being wholly independent.

4. **PLR 200812012 – Further Relaxation of Qualified Use**

In PLR 200812012, Trust A was established under the terms of the decedent's will to administer estate assets. The trust owned real property assets in various states which were held for investment. Under the terms of the will, Trust A terminated. Pursuant to a Termination Plan formulated by Trustees, Trust A assets were contributed to an LLC. The issue raised 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 held or managed the replacement property. The ruling distinguished Rev. Rul. 77-337, which involved "voluntary transfers of properties pursuant to prearranged plans."

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

*Magneson v. Com'r*, 753 F.2d 1490 (9<sup>th</sup> Cir. 1985), *aff'g*, 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 *Magneson*? Perhaps. While the IRS was not willing to impute the taxpayer's qualified use to the corporation, the Ninth Circuit, viewing the partnership under the aggregate theory, was apparently willing to impute the taxpayer's qualified use to the partnership.

**D. Summary of Qualified Use Cases, Rulings, Statutes and Regulations**

<b><u>Case, Ruling Regulation or Statute</u></b>	<b><u>Transaction</u></b>	<b><u>Qualified Use Violated?</u></b>	<b><u>Rationale</u></b>
<b>Rev. Rul. 75-292</b>	<b>Taxpayer transferred replacement property to wholly-owned corporation Immediately following exchange</b>	<b>YES</b>	
Rev. Rul. 77-297	Multiparty exchange involving accommodator	NO	Taxpayer can assist in locating and identifying replacement property
<b>Rev. Rul. 77-337</b>	<b>Distribution from wholly-owned owned corporation followed by exchange</b>	<b>YES</b>	
<i>Starker v. U.S.</i> 602 F.2d 1341 (9 <sup>th</sup> Cir. 1979)	Deferred exchange where replacement property acquired five years after transfer of relinquished property	NO	Exchanges need not be simultaneous
<i>Braur v. Com'r</i> 74 T.C. 1134 (1980)	Accommodator does not acquire legal title to replacement property	NO	Replacement property may be direct-deeded to taxpayer
<i>Garcia v. Com'r</i> 80 T.C. 491 (1983), <i>acq.</i> 1984-1 C.B. 1	Exchange funds held in escrow by accommodator; exchange intended	NO	Taxpayer's intent in is important, especially if transaction is consistent with exchange
<b>Rev. Rul. 84-121</b>	<b>Property acquired for purpose of engaging in like kind exchange</b>	<b>YES</b>	
PLR 8429039	Replacement property held for two years before sale	NO	Rule of administrative convenience
IRC §§ 1031(a)(3)(A), (B); (1984)	Taxpayer identifies replacement property within 45 days; acquires replacement property within 180 days	NO	Legislative adoption of <i>Starker v. U.S.</i> 602 F.2d 1341 (9 <sup>th</sup> Cir.) dispensing with requirement of simultaneity in exchange
<b>IRC § 1031(a)(2)(D) (1984)</b>	<b>Exchanges of partnership interests</b>	<b>YES</b>	<b>Legislation intended to prevent avoidance of boot recognition rules</b>
<i>Bolker v. Com'r</i> 81 T.C. 782 (1985)	Same as Rev. Rul. 77-337, except distribution and exchange part of single plan	NO	Taxpayer not required to hold property "indefinitely" to satisfy requirement
<i>Magneson v. Com'r</i> 753 F.2d 1490 (1985)	Taxpayer transferred replacement property to partnership following exchange	NO	

<u>Case, Ruling Regulation or Statute</u>	<u>Transaction</u>	<u>Qualified Use Violated?</u>	<u>Rationale</u>
<i>Mason Est. v. Com'r.</i> T.C. Memo 1988-273	Exchanges by former partners of property received from recently terminated partnerships	NO	Held to be exchange of assets individually rather than partnership assets; therefore no violation of Section 1031(a)(2)(D)
<i>Maloney v. Com'r</i> 93 T.C. 89 (1989)	Liquidating distribution of replacement property to shareholder month after exchange	NO	
<b>IRC § 1031(d) (1989)</b>	<b>Related party exchanges where Either party to exchange disposes of property within 2 years of exchange</b>	<b>YES</b>	<b>Statute intended to prevent “basis shifting” between related taxpayers</b>
Treas. Regs. §1.1031(k)-1(f)(1),(2) (1991)	Deferred exchanges with qualified intermediary	NO	Addresses problems of agency and constructive receipt; permits exchanges to be planned with element of certainty
PLR 9807013	SMLLC owned by taxpayer acquires replacement property	NO	SMLLC is disregarded for purposes of Section 1031 as well for income tax purposes
Rev. Proc. 2000-37	Acquisition of replacement property Prior to transferring relinquished property	NO	Administrative adoption of <i>Bezdjian v. Com'r.</i> , 845 F.2d 217 (9 <sup>th</sup> Cir. 1988) permitting “parking” transactions
Rev. Proc. 2002-22	Requirements for distribution of TIC interests not to result in tax partnership	NO	
Rev. Rul. 2004-86	Receipt of interests in Delaware Statutory Trust constitute receipt of qualifying property	NO	DST interest not subject to reclassification as trust; grantor treated as owner of real property owned by trust under § 677(a)
PLR 200521002	Trust entered exchange with intent of terminating and distributing replacement property to beneficiaries	NO	
<i>Moore v. Com'r</i> T.C. Memo 2007-134	Exchange of vacation home	YES	Property never rented
PLR 200812012	Trust assets contributed to LLC which then engaged in exchange	NO	
<i>Goolsby v. Com'r</i> T.C. Memo 2010-64	Taxpayer moved into replacement property two months after exchange	YES	Insufficient effort to rent; use of replacement property for personal “antithetical” to investment purpose

## **E. 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) the SMLLC being an entity different from that which transferred the relinquished property and (ii) the SMLLC violating the qualified use requirement by immediately acquiring the replacement property.

**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.

**F. 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 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 subject to the same federal tax law treatment as would the three entities, there would be no change in the manner in which the corporations conducted business. The ruling leaves open the question of how the IRS would view the acquisitions of a bankrupt or insolvent qualified intermediary by another entity.

**G. 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. The taxpayer and its wholly-owned LLC would acquire 100 percent of the interests of the 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. The ruling first addressed the issue of whether the exchange qualified for nonrecognition treatment. Answering in the affirmative, the ruling noted that 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 the taxpayer is treated as having acquired those interests from the partners rather than from the partnership. Accordingly, the transaction qualified as a like kind exchange, rather than a prohibited exchange of partnership interests. The second issue raised was whether the taxpayer may hold the replacement property in a newly-created state law entity that is disregarded for federal income tax purposes. Again answering in the affirmative, the ruling concluded that 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 taxpayer may hold the replacement property in a newly-created state law entity that is disregarded for federal income tax purposes without violating Section 1031.

**H. 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 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 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 had 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."

## 2. **Revenue Procedure 2008-16 Safe Harbor**

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 rents 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 does 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. The qualifying use period is (i) with respect to a vacation home sought to be

relinquished in an exchange the 24 month period immediately before the exchange; and (ii) with respect to a vacation home acquired as replacement property in an exchange the 24 month period following the exchange.

**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 both as 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. [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 for 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 also qualifies under Section 1031. *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. 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. Foreign Real Property Not of “Like Kind” to Domestic Real Property**

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.” One might infer by negative implication that foreign real property is of like kind to other foreign real property. However, since the statute is not explicit, it would appear inadvisable to proceed with an exchange based upon this inference without obtaining a prior ruling.

**3. Nonresident Withholding in Like Kind Exchanges**

Section 897 provides for the treatment of gain or loss

realized by a nonresident individual or foreign corporation that disposes of a United States real property interest. Section 1445 (subject to some exemptions) requires withholding of 10 percent of the amount realized (*i.e.*, sales price) in a transaction subject to Section 897. Where the seller is not a nonresident alien or foreign corporation, the title closer will prepare an affidavit certifying the non-foreign status of the seller.

**a. “Notice of Nonrecognition”  
for Simultaneous Exchanges**

If the seller is a nonresident alien or foreign corporation, the seller may file a “Notice of Non-Recognition” with the IRS if the exchange is simultaneous in accordance with IRC §1445 and include on the notice the transferor’s TIN, name and address. The transferor must present this notice to the transferee before the date of sale. The transferee must mail the notice of nonrecognition to the IRS no later than 20 days from the date of the exchange. If the notice of nonrecognition does not contain the transferor’s TIN, name and address, then the transferee cannot rely on the notice and is required to withhold tax.

**b. Withholding Certificate  
for Deferred Exchanges**

If the seller is a nonresident alien or foreign corporation, the seller may file Form 8288-B, “Application for Withholding Certificate for Disposition by Foreign Persons of U.S. Real Property Interests,” for a deferred exchange. The IRS website advises that since Form 8288-B requires a TIN. A transferor and/or transferee who does not qualify for an SSN may apply for an ITIN by attaching Form 8288-B to Form W-7 and mailing the documents to

Internal Revenue Service, Austin Service Center,  
ITIN Operation, PO Box 149342, Austin TX  
78714-9342.

**4. 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).

**5. New York Coops Are of Like Kind to Real Property**

The IRS blessed the exchange of cooperative shares in PLR 200631012. 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. This ruling followed PLR 200137032, which held that a taxpayer’s interest as a shareholder of a coop unit was of like kind to the taxpayer’s condominium ownership interest in the same unit after a conversion.

**6. Easements of Like Kind to Real Property**

PLR 9601046 held that conservation easements are of like kind to a fee interest in real estate where state law provided that the easement constituted an interest in real property.

7. **Development Rights Real Property Interests**

PLR 200901020 stated 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 or 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.

8. **Options to Acquire Real Property**

The IRS opined in FSA 1995-12 that an option to acquire real estate was of like kind to real estate, since the taxpayer’s money was still inextricably connected with real property of like kind. However, since the grant of an option is not a taxable event until the option is exercised, the grant by the taxpayer of an option to sell property owned by the taxpayer will not qualify as an exchange of property for purposes of Section 1031.

9. **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, whereupon 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 under the New Lease. New landlord would enter into a construction contract with independent construction company to construct leasehold improvements at the 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 were 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 asset 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) was not considered a Product Class. If property was listed in more than one Product Class, the property was 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 were 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 purchased and sold vehicles as the leases terminated. The taxpayer implemented a like kind exchange program pursuant to which the taxpayer exchanged vehicles through a qualified intermediary under a master exchange agreement. The taxpayer proposed 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  
To Tangible Personal Property Located in United States**

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**

It may be difficult to determine whether exchange property is real property or personal property. The 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 that the transaction 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, little 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 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 and Underlying Properties 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. Differences in “Grade or Quality” Inconsequential**

TAM 2000035055 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**

TAM 200602034 took 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. CCA 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.

3. **PLR 201024036 – Volatile Organic Compound (VOC) Credits and Nitrogen Oxide (NOx) Credits Are of Like Kind**

PLR 201024036 stated that Parent may exchange NOx Credits (achieved by installing air emission reduction equipment) obtained from subsidiary for VOC credits which it will need to offset its anticipated emissions of Volatile Organic Compounds. The Ruling noted that Rev. Proc. 92-91, Q & A 5 states that emission allowances may qualify as like-kind property for purposes of IRC § 1031. NOx Credits and VOC Credits are of the same “nature and character” since both are “part of [the government’s] program to control air pollution.” The Ruling then noted that although Nitrogen Oxide and Volatile Organic Compounds are “different chemical compounds” both are used to control nitrogen emissions. Therefore, the differences between the two compounds should be considered as differences in “grade or quality,” rather than “nature or character,” and are therefore of like kind.

V. **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.<sup>14</sup> Section 1031(d); Regs. § 1031(b)-1(c); *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<sup>15</sup> 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 10x dollars, but also pays 10x 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 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 10x dollars of liabilities but assumes only 5x dollars of liabilities in the exchange and is thus required to pay 5x dollars in cash. Although the taxpayer has net debt relief of 5x 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 5x 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 5x dollars and ends up with property having a mortgage of 5x dollars – the taxpayer should not be required to report boot gain in one situation but not the other.

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<sup>14</sup> This boot, as distinguished from cash boot, is sometimes referred to as “mortgage boot.”

<sup>15</sup> 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.”

## **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 is reduced 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 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 applied 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 (8<sup>th</sup> 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:

<u>Net Liabilities Relieved vs. Liabilities Assumed</u>	<u>Money or Other Property</u>	<u>May Money or Other Property Given Offset Liability Relief?</u>	<u>Boot Gain</u>	<u>Comment</u>
Net Liabilities Relieved	None	No Money	Liabilities Relieved - Liabilities Assumed	Nothing to Net
	<b>Given</b>	<b>Yes</b>	<b>Liabilities Relieved - Liab. Assumed - Boot Given</b>	<b>Netting Permitted</b>
	<b>Received</b>	<b>No</b>	<b>Liabilities Relieved - Liab. Assumed + Boot Rec’d</b>	<b>Netting Not Permitted</b>
Liabilities Relieved	None	No Money	None	Nothing to Net
Equal	Given	Yes	None	Netting Not Required
Liabilities Assumed	<b>Received</b>	<b>No</b>	<b>Cash Received</b>	<b>Netting Not Permitted</b>
	None	No Money	None	Nothing to Net
Net Liabilities Assumed	Given	Yes	None	Netting Not Required
	<b>Received</b>	<b>No</b>	<b>Cash Received</b>	<b>Netting Not Permitted</b>

## VI. 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.”<sup>16</sup>

### 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” 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 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)

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<sup>16</sup> 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.

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 constitutes 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 an 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 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 *Fredericks* type of pre-exchange financing appears to pose more tax risk than the type of financing accomplished in *Garcia*, the critical difference being that while the taxpayer in *Fredericks* received cash from a mortgage on property that was soon to be relinquished, the taxpayer in *Garcia* received no cash.

#### **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 the 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 to 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. 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 be 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.

## **VII. 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 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 would 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.

## VIII. Basis of Property Received in Exchange

### A. Calculation of Basis Adjustments in Like Kind Exchange

Section 1031(d) and the Regulations provide that the basis of property received in an exchange equals the **aggregate basis**<sup>17</sup> 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) gain recognized (*i.e.*, on the **receipt** of boot, or on the **transfer** of nonqualifying property); and
- (iii) liabilities associated with the replacement property.

### B. Basis Allocated First to Nonqualifying Property

Basis is first allocated to nonqualifying property received in the exchange 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).

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<sup>17</sup> Both qualifying (Section 1031) and nonqualifying (non-Section 1031) property.

**C. Illustration of Basis Allocation Where Boot Received in Exchange**

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) assumption of the \$150,000 mortgage; (iii) \$30,000 in cash; and (iv) 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 treated 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. IRC § 1031(b). 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 .....	<u>(\$ 180,000)</u>	
	Total Basis to be Allocated .....	\$ 520,000	
5.	Allocation of Basis	<u>Allocated</u>	<u>Remaining</u>
	Total Basis to Be Allocated .....		\$520,000
	First: To Picasso Sketch to extent of FMV	\$20,000	\$500,000
	Next: Remainder of Basis to Land .....	\$500,000	-0-

**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.

**D. Allocation of Consideration Received  
Where Boot is Given in Exchange**

Transferring nonqualifying property along with qualifying property will not take a transaction out of Section 1031. Where the taxpayer transfers qualifying and nonqualifying property in an exchange, the consideration received must be allocated between qualifying and nonqualifying property in proportion to their respective fair market values. Treas. Regs. § 1.1060-1(c)(2). 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**

Taxpayer exchanges a building, with an adjusted basis of \$1 million and a FMV of \$1.1 million, plus GM stock with an adjusted basis of \$400,000 and a FMV of \$200,000, for a vacant lot with a FMV 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 IRC § 1001(c) on the GM stock (\$400,000 - \$200,000). Gain realized from the exchange of the building for the vacant lot is not recognized because those properties are of like kind. IRC § 1031(c). 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 .....	<u>\$ 200,000</u>
c.	Loss realized and recognized .....	\$ 200,000
2.	Adjusted basis of relinquished building .....	\$ 1,000,000
	Plus: Adjusted basis of GM stock .....	<u>\$ 400,000</u>
	Aggregate basis of property transferred .....	\$ 1,400,000
3.	Aggregate basis of property transferred .....	\$ 1,400,000
	Less: Loss recognized on GM stock .....	<u>\$ 200,000</u>
	Basis of vacant lot .....	\$ 1,200,000

## **E. Transfers Involving Multiple Assets**

### **1. Former Method of Calculating Basis and Gain in Multiple Asset Exchanges**

A multiple asset exchange involves the sale of more than one property in an exchange and/or the acquisition of more than one replacement property in the exchange. A common example of a multiple-asset exchange is a real property sale that includes personal property (*i.e.* furniture and appliances). The transfer or receipt of multiple properties within one like-kind exchange group is also a multiple asset exchange. Reporting a multiple asset exchange requires supplementing Form 8824 with a statement describing how realized and recognized gain were determined.

### **2. Previous Method of Reporting Multiple Asset Exchanges**

Prior to the multiple asset exchange regulations, 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 their FMV. Consider the exchange of a 737 held for 5 months, with an adjusted basis of \$37 million and FMV \$40 million and a 727 held for 2 years with an adjusted basis of \$10 million and FMV \$20 million, for a 767 with a FMV of \$50 million, and \$10 million in cash.

#### **Relinquished 737**

Amount Realized	\$40 million
Adjusted Basis	\$37 million
Gain Realized	\$3 million
Boot Allocable	\$6.67 million
Gain Recognized	\$3 million of STCG

#### **Relinquished 727**

Amount Realized	\$20 million
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Adjusted Basis	\$10 million
Gain Realized	\$10 million
Boot Allocable	\$3.33 million
Gain Recognized	\$3.33 million of §1231 gain (LTCG)

**3. Property-by-Property Application of § 1031 Produced Favorable Results**

Note that even though total realized gain equaled \$13 million, and \$10 million in cash was received, recognized gain totaled only \$6.33 million. This result occurred because Section 1031 was applied on a property-by-property basis; the relinquished 737 produced only \$3 million of realized gain.

**4. 1991: Advent of Multi-Asset Exchange Regulations**

Since April 11, 1991, multiple asset exchange Regs § 1.1031(j)-1 set forth the exclusive method of basis computation for properties received in multiple property exchanges. 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.” The aggregate basis of properties received in each “exchange group” is the aggregate adjusted basis of the properties transferred within that exchange group, increased by the amount of gain recognized with respect to that exchange group, increased by the amount of “exchange group surplus,” or decreased by the amount of “exchange group deficiency,” and increased by the amount, if any, of excess liabilities assumed by the taxpayer that are allocated to that exchange group. 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. The basis of property received is determined on a property-by-property basis beginning by first ascertaining the basis of each property transferred and adjusting the basis of each property in the manner provided in § 1.1031(j)-1(c).

**a. “Exchange Group Deficiencies”  
May Produce More Gain**

Resulting “exchange group deficiencies” will often lead to less favorable boot gain results than would be the case prior to the multiple asset regulations. Thus, even if no cash is received in the exchange, it is possible that some of the gain realized in the transaction will be recognized.

**b. Example Provided in PLR 200842019**

Assume taxpayer exchanges Property A and Property B for Property C and Property D. The fair market values of the properties are as follows:

Property A \$100	Property C \$85
Property B \$250	Property D \$265

**c. Analysis**

Assume Property A is of like kind to Property C (but not to Property D), and the exchanging taxpayer has a \$0 adjusted basis in Property A and B. In this example, even though there is an exchange of like-kind properties worth \$350, the taxpayer is considered to have received \$15 of non-like kind property. That is, since Property A, with a fair market value of \$100, was exchanged for property C, which is worth \$85, the exchanging taxpayer is considered to have received \$15 worth of Property D for Property A; and Property D is not of like kind to Property A. Consequently, in accordance with the rules of Section 1.1031(j)-1, the taxpayer has \$15 of gain that is not deferred under Section 1031.

## **IX. 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.<sup>18</sup> 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 would be 10x dollars. That realized gain would be recognized to the extent of the 5x dollars in cash received. Although the initial basis would be increased by 5x dollars to reflect gain recognized in the exchange, basis would also be decreased by 5x dollars to reflect cash received in the exchange. Therefore, basis in the replacement property would remain 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 (8<sup>th</sup> Cir. 1050). Whether another party to the exchange *has* assumed a liability of the taxpayer is determined under Section 357(d).

#### **2. Compare: Realized Loss on Exchanged Property 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

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<sup>18</sup> 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.

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 does not operate to disallow loss on the transfer of nonqualifying property in an 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.*

**4. Receipt of Payment for Option Considered Boot**

If the taxpayer has entered into an option agreement whereby the purchaser paid for the right to purchase the relinquished property, the option payment will likely be considered

boot.

**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 exchange (*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 during the administration of an estate.

**C. Closing Costs Permitted to be Expensed Reduce Amount Realized**

The receipt of cash or other nonqualifying property would normally produce taxable boot to the extent of realized gain. However, Rev. Rul. 72-456 provided that brokerage commissions and many other transaction costs may be expensed, reducing gain realized and, in effect, also reducing recognized gain. *Blatt v. Com’r*, 67 T.C.M. 2125; T.C. Memo (1994-48) concurred, and held that expenses incurred **in connection with the exchange** and not deducted elsewhere on the taxpayer’s return may offset boot.<sup>19</sup> In such cases, the taxpayer may in effect “trade down.” *Blatt* suggested that the following expenses, incurred in connection with closing, should be allowed as exchange expenses:

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<sup>19</sup> 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.

## 1. Common Exchange Expenses

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

- a. Real estate commissions;
- b. Title insurance (owner's policy);
- c. Closing fees;
- d. Escrow fees;
- e. Legal fees;
- f. Transfer taxes;
- g. Recording deed fees;
- h. Inspection/testing fees;
- i. Survey fees
- j. QI Exchange Fees;

## 2. Illustration

Assume taxpayer sells real estate for \$1 million and pays \$10,000 of attorneys' fees in connection with the sale. At closing, the taxpayer receives exchange property worth \$900,000 and \$100,000 of cash. The "net selling price" would be \$990,000. If the taxpayer's adjusted basis in the property were \$900,000, \$90,000 of realized gain would result, all of which would be recognized. Note that had the attorneys' fee not been permitted as an expense, all of the \$100,000 of realized gain would have been recognized. Even though the attorneys' fees were paid in cash from exchange proceeds, that \$10,000 cash payment did not produce boot.

## D. Items Not Permitted to be Expensed But Permitted to Offset Boot

Some transactional items related to the exchange but not permitted to be expensed will constitute boot to the taxpayer-seller. To illustrate, assume closing occurs on June 15<sup>th</sup>, 2008, and that taxpayer-seller paid \$100,000 for an annual service contract on January 1<sup>st</sup>, 2008. The closing statement would reflect a credit to the taxpayer-seller of \$50,000. This item can offset boot paid by the taxpayer-

seller in the exchange. For example, assume taxpayer-seller collected rent of \$100,000 on June 1<sup>st</sup>, 2008. This would appear on the closing statement as a credit to the buyer, and would constitute boot to the taxpayer-seller. The taxpayer may net the boot paid (*i.e.*, the \$50,000 service contract credit) with the boot received (*i.e.*, the \$100,000 rent for the entire month). After netting, the taxpayer would report boot gain of \$50,000. The basis of the replacement property would be increased by the \$50,000 of gain recognized. The effect of the netting would be to capitalize the transactional item into the basis of the replacement property.

**E. Treatment of Expenses and Transactional Items Paid by QI and Related to Closing**

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, the payment by the QI during the exchange period could conceivably result in boot. In the worst case 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, thereby nullifying the like kind exchange.

**F. Treatment of Non-Exchange Expenses**

Some closing costs or transactional expenses that may be paid with exchange proceeds 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. Property liability insurance; and
3. Costs incurred to remove mechanic's liens

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

**1. Credit to Buyer-purchaser for Rents Collected by  
Taxpayer-seller but 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 Paid by Taxpayer-Seller**

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 it is treated as boot received. 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-taxpayer 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**

This would include (i) the 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.

**H. 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.

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

**1. Credit to Taxpayer-buyer for Rents Received by Seller  
But Which Are 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 boot paid by the taxpayer-buyer consists 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 receive 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, would 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.

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

**1. Credit Due to Seller for  
Prepaid Service Contracts**

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

**2. Prepaid Property Casualty and  
Liability Insurance Premiums**

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**

## HYPOTHETICAL

Wimbledon Investors, LLC, (“Wimbledon”) owns an office building in Great Neck with an adjusted basis of \$5.42 million that it has contracted to sell for \$10 million. The downpayment of \$1 million is being held by the attorney for Wimbledon in an attorney escrow account.<sup>20</sup> Wimbledon has engaged JPMorgan Chase (“Chase”) as QI, and has assigned its rights under the relinquished property contract and the earnest money deposit to Chase. Wimbledon has an outstanding principal balance of \$4,748,345 on a Citibank loan encumbering the relinquished property, which loan cannot be assumed and is subject to a prepayment penalty.

Wimbledon has contracted to purchase replacement property in Long Island City for \$11 million. If Wimbledon acquires the replacement property within the 45-day identification period, the “actual purchase” rule will be satisfied. Wimbledon entered into the purchase and sale contract for the Long Island City property prior to engaging Chase as QI. Accordingly, Wimbledon paid the \$1,100,000 downpayment from its own funds, but will be reimbursed from 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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<sup>20</sup> 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 an interest bearing escrow account. The choice of which type of escrow account into which the earnest money is deposited has no effect on the exchange.

**RELINQUISHED PROPERTY CLOSING STATEMENT: TAXPAYER-SELLER'S TRANSACTION**

SELLER:	J.P. Morgan Exchange, Inc., as QI for Wimbledon Investors, LLC	
BUYER:	Adirondack Properties, LLC	
PROPERTY:	Office Building at 11111 Northern Boulevard, Great Neck, NY 10021	
DATE:	December 15, 2008, 10:00 AM	
<b>Purchase Price</b>		<b>\$ 10,000,000</b>
<b>Plus:</b>		
	Credit due to taxpayer for escrow deposits that pass to buyer [BOOT PAID]	\$ 50,243
	Credit due to taxpayer for prorated prepaid service contracts [BOOT PAID]	\$ 13,387
	Credit due to taxpayer for prorated prepaid property taxes [BOOT PAID]	11,123
	<b>Subtotal</b>	<b>\$ 74,753</b>
<b>Less:</b>		
	<b>Earnest Money Deposit</b>	<b>\$ 1,000,000</b>
	Credit to Buyer for prorated post-closing rent retained [BOOT RECEIVED] <sup>21</sup>	20,000
	Unpaid accrued utility charges assumed by buyer [BOOT RECEIVED] <sup>22</sup>	14,439
	Credit due to Buyer for security deposits retained [BOOT RECEIVED] <sup>23</sup>	17,500
	<b>Payoff for Citibank Loan (receipt of cash)</b>	
	Principal balance [BOOT RECEIVED] <sup>24</sup>	4,748,345
	Accrued interest through closing date [BOOT RECEIVED]	32,432
	Prepayment penalty [BOOT RECEIVED]	20,000
	<b>Broker's Commission</b> [EXPENSE]	<b>400,000</b>
	<b>Attorneys' fees</b> [EXPENSE]	<b>10,000</b>
	<b>Recording Fees</b> [EXPENSE]	<b>140,000</b>
	<b>Qualified Intermediary exchange fee</b> [EXPENSE]	<b>P.O.C.<sup>25</sup></b>
	<b>Subtotal</b>	<b>\$ 6,402,716</b>
	<b>Balance due Seller</b>	<b>\$ 3,672,037</b>
	<b>Funds delivered to Qualified Intermediary</b>	<b>\$ 4,672,037<sup>26</sup></b>

<sup>21</sup> If boot is a problem, taxpayer-seller can place unearned rent into an escrow account and refund the escrow to buyer at closing. More money will pass to QI, since there will be no reduction in purchase price. (If boot is not a problem, taxpayer-seller might prefer to retain cash).

<sup>22</sup> If boot is a problem, taxpayer can prepay these charges. More money will pass to QI.

<sup>23</sup> If boot is a problem, taxpayer-seller can refund escrowed security deposits to buyer at closing. More money will pass to QI. Again, if boot is not a problem, then taxpayer may prefer to keep cash.

<sup>24</sup> If boot is a problem, taxpayer can (i) prepay existing mortgage balance prior to closing or (ii) even-up mortgage on replacement property. However, IRS could assert step transaction doctrine.

<sup>25</sup> Qualified Intermediary exchange fee of \$1,000 paid out of closing; deducted from exchange funds after closing.

<sup>26</sup> \$3,672,037 balance due at closing plus \$1,000,000 earnest money deposit.

**REPLACEMENT PROP. CLOSING STATEMENT: TAXPAYER-BUYER'S TRANSACTION**

SELLER:	Atlantis Properties, LLC, a New York Limited Liability Company		
BUYER:	J.P. Morgan Exchange, Inc., as QI for Wimbledon Investors, LLC		
PROPERTY:	Commercial building at 1201 Skillman Avenue, Long Island City, NY		
DATE:	December 28, 2008, 10:00 AM		
<b>Purchase Price</b>			<b>\$ 11,000,000</b>
<b>Less:</b>	<b>Credit due to Taxpayer for prorated rent collected by seller</b>	<b>[BOOT PAID]<sup>27</sup></b>	<b>\$ 2,750</b>
	<b>Credit due to Taxpayer for Seller's accrued property taxes</b>	<b>[BOOT PAID]<sup>28</sup></b>	<b>13,387</b>
	<b>Credit due to Taxpayer for security deposits retained by seller</b>	<b>[BOOT PAID]<sup>29</sup></b>	<b>11,123</b>
	<b>Earnest money deposit paid by Taxpayer (refunded to taxpayer at closing)</b>		<b><u>1,100,000</u></b>
	<b>Subtotal</b>		<b>\$ 1,127,260</b>
<b>Plus:</b>	<b>Credit due to Seller for prorated prepd service contracts</b>	<b>[BOOT REC'D]<sup>30</sup></b>	<b>\$ 9,600</b>
	<b>Credit to Seller for Prepaid per diem interest on loan</b>	<b>[BOOT REC'D]<sup>31</sup></b>	<b>19,540</b>
	<b>Credit to Seller for Prepd proptry casulty &amp; liab. ins. prem</b>	<b>[BOOT REC'D]<sup>32</sup></b>	<b>9,500</b>
	<b>Title insurance – lender's policy</b>	<b>[BOOT REC'D]</b>	<b>9,000</b>
	<b>Appraisal fee</b>	<b>[BOOT REC'D]</b>	<b>7,500</b>
	<b>Loan Origination Fee</b>	<b>[BOOT REC'D]</b>	<b>80,000</b>
	<b>UCC search fees</b>	<b>[BOOT REC'D]</b>	<b>275</b>
	<b>Survey</b>	<b>[EXPENSE]</b>	<b>2,000</b>
	<b>Attorneys' fees</b>	<b>[EXPENSE]</b>	<b>10,000</b>
	<b>Recording fees</b>	<b>[EXPENSE]</b>	<b>150</b>
	<b>Environmental study</b>	<b>[EXPENSE]</b>	<b>6,500</b>
	<b>Title insurance – owner's policy</b>	<b>[EXPENSE]</b>	<b>22,000</b>
	<b>Qualified Intermediary exchange fee</b>	<b>[EXPENSE]</b>	<b><u>P.O.C.<sup>33</sup></u></b>
	<b>Subtotal</b>		<b>\$ 176,065</b>
	<b>Total due from Buyer</b>		<b>\$ 10,048,805</b>
	<b>Deposit from Qualified Intermediary</b>		<b>\$ 3,571,037<sup>34</sup></b>
	<b>Balance due to Seller – Loan proceeds from HSBC</b>	<b>[BOOT PAID]</b>	<b><u>\$ 6,477,768</u></b>

<sup>27</sup> If boot is not a problem, taxpayer may prefer to receive cash. The rental income is taxable to buyer in either case.

<sup>28</sup> If boot is not a problem, taxpayer may prefer to receive cash.

<sup>29</sup> If boot is not a problem, taxpayer may prefer to receive these escrowed deposits.

<sup>30</sup> If boot is a problem, taxpayer may pay seller before closing.

<sup>31</sup> If boot is a problem, taxpayer may pay seller before closing.

<sup>32</sup> If boot is a problem, taxpayer may pay seller before closing.

<sup>33</sup> QI exchange fee of \$1,000 paid out of closing; deducted from exchange funds after closing.

<sup>34</sup> 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.

Check:	Net Credits to Seller:	\$ 11,380
	Purchase Price:	\$ 11,000,000
	Amt Due Seller w/credits	\$ 11,011,380
Less:	Deposit	\$ 1,100,000
	<b>Net due Seller</b>	<b><u>\$ 9,911,380</u></b>
	Total Due from Buyer:	\$ 10,048,805
	Less buyer expenses paid from escrow	\$ 137,425
	<b>Total remaining for seller</b>	<b>\$ 9,911,380</b>

**CLASSIFICATION OF TRANSACTIONAL ITEMS**

<b>1. Relinquished Property Exchange Expenses:</b>			
Broker's commission	\$	400,000	
Recording fees			140,000
Attorneys' fees			10,000
Qualified Intermediary exchange fee			<u>1,000</u>
	<b>TOTAL</b>		<b><u>\$551,000</u></b>
<b>2. Relinquished Property Prorations and Other</b>			
Transactional Items Treated as Boot Received by Seller:			
Credit due to Buyer for prorated rent (after closing rent kept by seller)	\$	20,000	
Credit due to Buyer for security deposits (deposits kept by seller)			17,500
Accrued utility charges (Liability assumed by buyer)			<u>14,439</u>
	<b>TOTAL</b>		<b><u>\$ 51,939</u></b>
<b>3. Relinquished Property Prorations and Other</b>			
Transactional Items Treated as Boot Paid by Seller:			
Credit due to Seller for escrow deposits with lender (cash foregone)	\$	50,243	
Credit due to Seller for prorated prepaid service contracts (prepaid liab.)			13,387
Credit due to Seller for property taxes paid through 12/31/08 (prepd liab.)			<u>11,123</u>
	<b>TOTAL</b>		<b><u>\$ 74,753</u></b>
<b>4. Replacement Property Exchange Expenses:</b>			
Title Insurance – owner's policy	\$	22,000	
Attorneys' fees			10,000
Environmental study			6,500
Survey			2,000
Recording fees			<u>150</u>
	<b>TOTAL</b>		<b><u>\$40,650</u></b>
<b>5. Replacement Property Loan Costs Treated as Boot Received by Buyer:</b>			
Title Insurance – lender's policy (cash otherwise wld have gone to QI)	\$	9,000	
Appraisal fee (Cash otherwise would have gone to QI)			7,500
Loan origination fee (cash otherwise would have gone to QI)			80,000
UCC search fees (cash otherwise would have gone to QI)			<u>275</u>
	<b>TOTAL</b>		<b><u>\$ 96,775</u></b>
<b>6. Replacement Property Prorations and Other</b>			
Transactional Items Treated as Boot Received by Buyer:			
Credit due to Seller for prorated prepaid service contracts (prepd liab.)	\$	9,600	
Prepaid property and casualty liability insurance premium (prepd liab.)			9,500
Prepaid per diem interest on new loan			<u>19,540</u>
	<b>TOTAL</b>		<b><u>\$ 38,640</u></b>
<b>7. Replacement Property Prorations and Other</b>			
Transactional Items Treated as Boot Paid by Buyer:			
Credit due to Buyer for prorated rent received by seller (cash foregone)	\$	2,750	

\	Credit due to Buyer for Seller's portion of accrued taxes (liab. assumed)	13,387
	Credit due to Buyer for prorated security deposits (cash foregone)	<u>11,123</u>
	<b>TOTAL</b>	<b><u>\$ 27,260</u></b>

**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		<u>(38,640)</u>
<b>Net boot paid (received) on prorations and transactional items</b>		<b><u>\$ (85,341)</u></b>
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	<u>20,000</u>	(4,800,777)
Plus replacement property liabilities assumed		
New mortgage loan		<u>6,477,768</u>
<b>Net boot paid (received)</b>		<b><u>\$1,591,650</u></b>

**GAIN REALIZED AND RECOGNIZED  
ON SALE OF RELINQUISHED PROPERTY**

<b>Selling Price of Relinquished Property</b>		<b>\$10,000,000</b>
<b>Less selling/purchasing expenses</b>		
Selling expenses of relinquished property	\$551,000	
Purchase expenses of replacement property	<u>\$ 40,650</u>	<u><b>591,650</b></u>
Net selling price of relinquishes property (i.e., Amount Realized)		<b>\$9,408,350</b>
<b>Less adjusted basis of relinquished property</b>		<b>5,420,000</b>
<b>Gain Realized</b>	<b>A</b>	<u><b>\$3,988,350</b></u>
<b>Net boot received</b>	<b>B</b>	<b>\$ -0-</b>
<b>Gain Recognized – lesser of A or B</b>		<b>\$ -0-</b>
<b>Deferred Gain</b>		<u><b>\$3,988,350</b></u>

**BASIS OF REPLACEMENT PROPERTY**

<b>Basis of relinquished property</b>	<b>\$5,420,000</b>
<b>Gain recognized</b>	<b>-0-</b>
<b>Add net boot paid</b>	<b><u>1,591,650</u></b>
<b>Basis of replacement property</b>	<b><u>\$7,011,650</u></b>
<b>Check:</b>	
<b>Purchase price of replacement property</b>	<b>\$11,000,000</b>
<b>Deferred gain</b>	<b>3,988,350</b>
<b>Basis of replacement property</b>	<b>\$7,011,650</b>

## **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 purposes of determining whether property is Section 1245 property or Section 1250 property.

#### **1. CCA 201238027 Memo Regarding State Law Characterization**

Using four illustrations, counsel for the IRS articulated the differences between state law characterization of whether property is “real” or “personal” and whether property is of the same “nature and character” so as to qualify for like kind exchange treatment under Section 1031.

- a.** In the first illustration, two natural gas pipelines situated in different states were exchanged. In State A the pipeline was classified as personal property, while in the State B the pipeline was classified as real property. Since the pipelines were of the same “nature and character” they were of like kind and qualified for exchange treatment. Since the pipelines were “inherently permanent structures that are affixed to real property” they were considered to be real property for purposes of Section 1031. The memorandum added that in applying Treas. Regs. §1.1031(j), relating to the exchanges of multiple properties, the natural gas pipelines should be treated as real property and included in the real property exchange group.
- b.** The second illustration involved an exchange of “steam turbines” which were again characterized differently under two states’ law. The IRC concluded that the steam turbines were of like kind for purposes of Section 1031. However, in this illustration, the turbines

were “attached as fixtures” to land, which was also exchanged. Here, since the steam turbines were “machinery used in the commercial production of electricity,” and not “structural components” of the building. Since the turbines are of like kind, they should not be treated as part of the real property exchange group when applying Treas. Regs. §1.1031(j).

- c. “Case 3” involved the exchange of a steam turbine attached as a fixture to a building which is treated as real property under state law for land. Although characterized under state law as real property, the steam turbine is not of the same “nature and quality” as raw land and is not of like kind to the land. (The turbine should also not be part of the real property exchange group.)
- d. The final illustration involved the exchange of a steam turbine and a natural gas pipeline, both considered real property in State A, for a natural gas pipeline treated as personal property in State B. (The land, buildings, and right of ways associated with the turbines and pipelines were also exchanged in the transaction.) Here, the exchange of natural gas pipelines constituted a good exchange; however, the steam turbine is not of like kind to the natural gas pipeline, which would result in boot. In addition. The natural gas pipelines, as in the first illustration, should be treated as real property when applying Treas. Regs. §1.1031(j). As in the second illustration, the steam turbines should be treated as personal property and should not be included as part of the real property exchange group.

## **B. Section 1250 Property Defined**

Section 1250 property, defined by exclusion, consists of 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.<sup>35</sup>

**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).<sup>36</sup> 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. 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 that he has owned for seven years. The property has a fair market value of \$3

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<sup>35</sup> 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.

<sup>36</sup> 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.

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 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 [ $(\$600,000/39) + (2/7) \times \$200,000$ ].

### **3. Cost Segregation Most Effective When Basis is High**

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, constitutes a “single purpose agricultural structure” under Section 1245(a)(3)(D). Section 1031 largely defers to local law in determining whether property is real or personal and it is remote that a barn would not be classified as real property for local law purposes.<sup>37</sup> 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 is a local law determination.

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<sup>37</sup> However, in other cases 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.

## 2. Dual Characterization Could Enhance Exchange

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 could enjoy the best of both worlds: faster depreciation and qualification as real property for future exchanges. 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,<sup>38</sup> boot gain will result. Therefore, 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

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<sup>39</sup>, 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

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. Boot gain could also result

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<sup>38</sup> 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.

<sup>39</sup> IRC §1245(b)(4).

if the Section 1245 property relinquished is not of “like class” to the Section 1245 property received in the exchange. 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, 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.

#### **a. Extent of Depreciation Recapture**

Section 1245(b)(4) provides that if property is disposed of in a §1031 exchange, depreciation recapture cannot exceed the amount of gain recognized without regard to Section 1245 **plus** the FMV of non-Section 1245 property acquired in the exchange. Therefore, Section 1245 recapture cannot exceed the sum of (i) boot gain and (ii) the extent to which Section 1245 property relinquished in the exchange exceeds Section 1245 property received in the exchange. IRC § 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. In this respect, the boot rules of Section are more restrictive

than the recapture rules of Section 1245.

**E. Minimizing Section 1245 Property Relinquished**

The extent of depreciation recapture may depend on the value of Section 1245 property relinquished versus the value of Section 1245 property received in an 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, Regs. § 1.1245-1(a)(5) requires the total amount realized on the disposition 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. Unrecaptured Section 1250 Gain**

Property subject to unrecaptured Section 1250 gain is taxed at 25 percent when sold. Section 1(h)(7). This rate is 10 percent higher than the usual rate imposed for long term capital gains. The higher rate serves as a proxy for depreciation recapture. 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 deferred unrecaptured Section 1250 gain would roll over into the replacement property.

**b. Section 1250 "Additional Depreciation" Recapture Rare**

Although Section 1250 recapture with respect to which "additional depreciation" has been taken, can also occur in an exchange, TRA 1986 generally

required that all real property be depreciated on a straight line basis. Therefore, Section 1250 recapture should no longer be an issue in most exchanges. Section 1031(d)(4)(D); Regs. § 1.1250-3(d)(5).

#### **G. Allocation of Basis Upon Reclassification**

Basis must be allocated to reclassified replacement property consisting 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.

#### **H. Example of Depreciation Recapture in Taxable Sale**

Taxpayer sells a building containing Section 1245 property on June 30<sup>th</sup>, 2006, for \$1 million. The building had originally cost \$700,000. Depreciation deductions of \$300,000 had been taken, of which \$100,000 was subject to ordinary income depreciation recapture under Section 1245(a)(2). The sale would result in

- (i) \$100,000 of “excess” depreciation under Section 1245 taxed at 35 percent;
- (ii) \$200,000 of unrecaptured Section 1250 gain taxed at 25 percent; and
- (iii) \$300,000 of long term capital gain taxed at 15 percent.

A NYC taxpayer would incur a tax of \$236,220, resulting in an effective tax rate of 39.37 percent, computed as follows:  $[(\$100,000 \times .35) + (\$200,000 \times .25) + (\$300,000 \times .15) + (\$600,000 \times .0897)^{40} + (\$600,000 \times .0365)^{41} + (\$1,000,000 \times$

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<sup>40</sup> NYS income tax

<sup>41</sup> NYC income tax

$$.004)^{42} + (\$1,000,000 \times .02625)^{43}].$$

## 1. Compare to Section 1031 Exchange

If this property were instead exchanged, all of the LTCG and all of the unrecaptured Section 1250 gain would be deferred. The fate of the Section 1245 recapture gain would depend on whether more Section 1245 property was relinquished in the exchange than was received.<sup>44</sup> The only tax that could not be deferred in the exchange would be the combined state and local transfer tax liability of \$30,500.

## I. Depreciation of Property Acquired in Like Kind Exchange

### 1. Treas. Reg. § 1.168(i)-6 and Election Out

Treas. Reg. § 1.168(i)-6 governs the method of depreciating property acquired in a like kind exchange. The taxpayer may elect out of applying Reg. § 1.168(i)-6 by indicating on Form 4562 “Election Made Under Section 1.168(i)-6T(i).” If an election out is made, the taxpayer calculates depreciation based upon the entire basis of the replacement property at the time it is placed in service.

### 2. Depreciation Under Treas. Reg. § 1.168(i)-6

#### a. Concept of “Old Basis” and “New Basis”

If no election is made not to apply Treas. Reg. § 1.168(i)-6, the basis of replacement property will consist of (i) “Old Basis” and (ii) “New Basis”. Old Basis is the adjusted basis of relinquished property, while New Basis is any additional basis arising in the exchange. In general, an election out may be desirable when the recovery period or depreciation method of the replacement property is different from that of the relinquished property. If an election out is made, the replacement property is depreciated using the recovery period and depreciation method of the replacement property, even

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<sup>42</sup> NYS transfer tax

<sup>43</sup> NYC transfer tax

<sup>44</sup> If the amount of Section 1245 property relinquished in the exchange did not exceed the amount of Section 1245 property received in the exchange, no ordinary income recapture under Section 1245 would result.

if the recovery period is shorter and the depreciation method faster.

**b. Commencement and Method of  
Depreciation for Replacement Property**

*No depreciation is allowed during the exchange period.* Accordingly, depreciation with respect to “Old Basis” and “New Basis” will both commence when the replacement property is acquired. The depreciation allowed will depend upon whether the replacement property has (i) a longer (or shorter) MACRS recovery period than the relinquished property and (ii) a slower (or faster) depreciation method than the relinquished property had.<sup>45</sup>

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<sup>45</sup> To illustrate the mechanics of Regs. § 1.168(i)-6:

- (1) If the replacement property has a slower depreciation method than the relinquished property, then the Old Basis is depreciated under that slower method;
- (2) If the replacement property has a faster method of depreciation than the relinquished property, then depreciation will be calculated using the slower depreciation method of the relinquished property;
- (3) If the replacement property uses a longer recovery period than the relinquished property, then the Old Basis is depreciated using the recovery period of the replacement property, assuming for the purpose of calculating the new recovery period, that the replacement property was placed in service on the same date that relinquished property had been placed in service. (For example, assume 15 year property acquired 15 years ago is replaced with 39 year property. The recovery period for the 39 year replacement property would be 24 years (*i.e.*, 39 years - 15 years); and
- (4) If the replacement property uses a shorter recovery period than the relinquished property, the Old Basis will continue to be depreciated over the remaining recovery period of the relinquished property without any change.

## **XI. Related Party Transactions**

### **A. Overview of Statute**

XII. Section 1031(f) was enacted as part of RRA 1989 to eliminate revenue losses associated with “basis shifting” in related party exchanges. Basis shifting occurs when related persons exchange high basis property for low basis property, with the high basis (loss) property being sold thereafter by one of the related persons and gain on the low basis property being deferred. Basis shifting allows the parties to retain desired property but shift tax attributes.<sup>46</sup> Section 1031(f)(1) causes deferred realized gain to be recognized if, within 2 years, either related party disposes of exchange property, unless the disposition falls within one of three exceptions, the most important of which being that the exchange does not have as “one of the principal purposes” was tax avoidance. On the other hand, even if an exchange is outside the literal scope of the statute (*i.e.*, by engaging a QI, but was “structured” to avoid the related party rules, the entire exchange will fail under Section 1031 *ab initio*.

#### **1. Related Person Described**

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

##### **a. Section 267(b)**

Section 267(b) provides that related parties include (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

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<sup>46</sup>

S. Rep. No. 56, 101<sup>st</sup> Cong., 1<sup>st</sup> Sess. 151 (1989).

the profits interest in the partnership.

**(1) Attribution Rules of Section 267(c)**

Section 267(c) provides for constructive ownership of stock. For example, Section 267(c)(1) provides that stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust shall be considered as being owned proportionately by or for its shareholders, partners, or beneficiaries. Similarly, an individual is considered as owning stock owned, directly or indirectly, by or for his family. IRC § 267(c)(2).

**b. Section 707(b)(1)**

Section 707(b)(1) provides that related parties include (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.

**B. 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.<sup>47</sup>

## **1. Illustration**

### **a. Direct Exchange**

Son owns Florida swampland with a basis of \$2 million, and a FMV of \$1 million. Father owns a fully depreciated Manhattan building with a basis of 0, and a FMV of \$1 million. 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 recognized a \$1 million loss, with Father's \$1 million gain being deferred. The exchange would have had the effect of deferring recognition of Father's gain, and accelerating Son's \$1 million loss. Section 1031(f) now requires Father to recognize deferred gain in the exchange if, within 2 years of the exchange, either Son or Father disposes of property acquired in the exchange. Therefore, if either Father or Son disposes of property acquired in the exchange after one year, deferral of Father's gain will cease. IRC § 1031(f)(1)(C)(i),(ii); *see* PLR 200712013.

### **(1) Either Property Sold After Death of Father or Son**

If either Father or Son dies within two years of the exchange, and a sale occurs by either Father or Son (or by either of their estates) of property acquired in the exchange, the related party rules will have no

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<sup>47</sup> Section 1031(g) suspends the running of the 2-year period during any time when an exchanging 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 (4<sup>th</sup> Cir. 1963); Revenue Ruling 61-119, 1961-1 C.B. 395.

application. IRC § 1031(f)(2)(A).<sup>48</sup>

**b. Indirect Exchange**

If instead of a direct exchange between Father and Son, Father sold the building to a cash buyer through a qualified intermediary, and identified Son's property as replacement property. In this case, there will have been no direct exchange between Father and Son. However, if IRS asserts that the exchange was motivated by tax avoidance, then the exchange treatment will be denied from the start. *Teruya Brothers Ltd. v. Com'r*, 124 T.C. No. 4 (2005); *aff'd* 9<sup>th</sup> Cir. No. 05-73779 (Sept. 8, 2009); *Ocmulgee Fields v. Com'r* (T.C. No. 6 (2009); *aff'd* 11<sup>th</sup> Cir. No. 09-13395 (2010).

**c. No Basis Shifting**

If Son purchased the Florida swampland merely to accommodate Father's desire to engage in an like kind exchange, and the transaction was not motivated by tax avoidance, then a disposition within two years by either Father or Son will not affect Father's Section 1031 exchange. §1031(f)(2)(C). PLR 200712013.

**d. Repurchase by Father**

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. *Court Holding Company v. Com'r*, 45-1 USTC ¶9215, 324 U.S. 331, 65 S.Ct. 707 (1945)

**C. "Disposition" Defined**

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<sup>48</sup> If the initial exchange was motivated by tax avoidance, IRC §1031(f) could operate to deny exchange treatment.

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 purpose 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, 101<sup>st</sup> Cong., 1<sup>st</sup> Sess. 151-152 (1989).

## **1. 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.

## **2. “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. PLR 200712013.

### **3. 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). 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.

### **4. 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.

### **5. Two Year Rule 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. However, the “catch all” in § 1031(f)(4) warns that “[t]his *section* shall not apply to any exchange

which is part of a transaction (or series of transactions) structured to avoid the purposes of this subsection.” *The word “section” refers to Section 1031 itself*, and not to subsection § 1031(f)(4). Therefore, a straightforward interpretation of the statute would seem to lead to the conclusion that like kind exchange treatment is not possible if § 1031(f)(4) is violated, regardless of whether two years elapses before a related party disposes of property acquired in the exchange.

## **6. 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 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.

## **7. “Insurance” Against Lapsing of Replacement Period**

May the taxpayer identify (within the 45-day identification period) and acquire replacement property from a related party as insurance against the possibility that other identified properties owned by unrelated parties cannot be acquired within the 180-day exchange 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.

## **D. Cases and Rulings Interpreting Related Party Rules**

### **1. PLR 201220012**

In PLR 201220012, the IRS stated that where related parties engaged in exchanges through qualified intermediary and affiliates, the application of Section 1031(f) would not result in loss of

exchange treatment. The Ruling cited the Legislative History of the House and Ways Committee and Senate Finance Committee, which cited the concern that exchanges between related parties would result in a related parties being “cashed out”. However, the Ruling also noted that the Legislative History cited three examples where tax-avoidance would not be deemed a “principal purpose” of the transaction. One of these was where the property in the exchange was itself disposed of in a non-recognition transaction. In the facts of the Ruling, the only acquisitions of replacement property from related parties would be as part of subsequent like-kind exchanges. An important element of the Ruling was that the amount of boot received in the exchange would constitute no more than 5 percent of the realized gain.

## **2. [PLR 201216007](#)**

In this Ruling, the IRS approved a transaction in which an Operating Partnership (OP) engaged in a reverse exchange in which it identified and acquired replacement properties owned by a related Affiliate. Affiliate, in turn, intends to engage in its own like kind exchange with respect to those properties in a deferred exchange. OP represented that the gain recognized by either it or Affiliate in the exchange will not exceed five percent of those entities’ respective realized gain. The rationale provided by the IRS was similar to that stated in PLR 201220012:

In the present case, the only acquisitions of replacement property from related parties will be as part of subsequent like-kind exchanges by the related parties, which will substantially constitute nonrecognition transactions. OP will be relinquishing property to Taxpayer as part of its own like-kind exchange with one or more related parties (Affiliates), and the Affiliates will relinquish property to OP as part of their separate like-kind exchanges for replacement property from one or more unrelated parties. Since both OP and any transferring Affiliate will also structure its disposition of property as an exchange for like-kind replacement property, neither §1031(f)(1) nor (f)(4) apply to trigger gain recognition.

## **3. [Technical Advice Memorandum 9748006](#)**

In TAM 9748006, the taxpayer transferred property to an unrelated party through a qualified intermediary, and acquired his mother's property through a qualified intermediary 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 an exchange structured through "a qualified intermediary is not entitled to better treatment than the related party referred to in the House Budget Committee Report."

**4. Field Service Advisory (FSA) 199931002**

In FSA 199931022, the taxpayer engaged a qualified intermediary 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 taxpayer's sale of the replacement property within two years of the exchange violated Section 1031(f)(4), since the replacement property had been acquired from a related party. .

**5. 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. Citing Section 1031(f)(4), the ruling concluded that the engagement of a QI was part of a transaction structured to avoid the related party rules. 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.<sup>49</sup>

**6. Teruya Brothers Ltd. v Com'r**

In *Teruya Brothers Ltd. v. Com'r*, 124 T.C. No. 4 (2005), the

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<sup>49</sup> TAM 9748006 FSA 199931002, and Rev. Rul. 2002-83 address exchanges involving replacement property originating from a related party. However, the statute would also apply to situations where the a related party acquires the taxpayer's relinquished property, and the taxpayer identifies and acquires new replacement property from an unrelated party through the QI.

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). *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. 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 Tax 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 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).

**7. Ocmulgee Fields v. Com'r (T.C. No. 6 (2009)).**

In *Ocmulgee Fields*, 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 the substitution of a 15 percent tax rate for a 34 percent tax rate. After *Ocmulgee*, 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.

**a.      Eleventh Circuit Affirms *Ocmulgee***

The Eleventh Circuit affirmed the Tax Court, concluding that “the substantive result of *Ocmulgee Fields*’ series of transactions supports an inference that *Ocmulgee Fields* structured its transactions to avoid the purposes of § 1031(f). . .” The court reasoned that even if *Ocmulgee* had not interposed a qualified intermediary, the transaction would fail because it could not establish the “lack of tax avoidance” exception in § 1031(f)(2)(C). The court found no “persuasive justification” for the complexity of its transaction other than one of “tax avoidance.” Although *Ocmulgee* argued on appeal that tax avoidance was not a “principal purpose” of the exchange, the court found that the basis-shifting, reduction in immediate taxes, and shifting of the tax burden to the party with the lowest tax rate all justified negative “inferences” against the taxpayer. Finally, although *Ocmulgee* argued that it had a legitimate business purpose for the exchange, it failed to establish clear error. Moreover, the “mere existence of legitimate business purposes does not preclude a finding that *Ocmulgee Fields*’ principal purpose for the exchange was tax avoidance.” *Ocmulgee Fields, Inc., v. CIR*, No. 09-13395 (2010).

**8.      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. The Trust received some cash boot in its 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.

**9. 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 exchange 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 would not apply.

**10. PLR 200712013**

**a. Facts**

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 EAT, which acquired Whiteacre. The taxpayer and the related party entered into a contract for the sale of Blackacre for cash. The taxpayer identified Blackacre and assigned all rights in this contract to a QI. The QI

transferred title in Blackacre to the related party for cash, which was transferred to the EAT. The EAT then direct deeded title in Whiteacre to the taxpayer and extinguished the taxpayer's debt, thus completing the reverse exchange.

**b. 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 basis shifting occurred, and 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).

**11. 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 interests 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).

**12. Chief Counsel Memorandum 20103038**

In CCM 20103038, the taxpayer, an auto dealer, attempted to structure a like kind exchange between itself and dealer, who were related parties under IRC § 267. Citing *Teruya Brothers, Ocmulgee Fields*, and Rev. Rul. 2002-83, IRS counsel concluded that the taxpayer “structured its transaction to achieve the impermissible result that Congress addressed in the legislative history.” It then concluded that the “no tax avoidance” exception of IRC § 1031(f)(2)(C) was inapplicable, since qualification under the exception requires that tax avoidance not be “one” of its principal purposes. Therefore, even if other, non-tax avoidance purposes existed, the existence of any tax avoidance purpose would result in the inapplicability of the exclusion. The advisory concluded that

[a]s a matter of interpretation, the Service has consistently limited the § 1031(f)(2)(C) exception to the situations Congress so specifically described in the legislative history. See Rev. Rul. 2002-83. We are not willing to expand the exception to cover the Taxpayer’s situation.

**13.     PLR 201027036**

PLR 201027036 involved an exchange among a group of companies with a common parent. The ruling blessed the transaction. No direct exchange between the parties occurred by reason of the interposition of a qualified intermediary. Therefore, IRC § 1031(f)(1) was by its terms inapplicable. IRC § 1031(f)(4) was inapplicable since the related parties did not exchange high basis property for low basis property. Therefore, no “cashing out” occurred.

**E.     Reporting Related Party Exchanges**

Form 8824 (“Like Kind Exchanges”) requires the taxpayer to state (i) the name, relationship, and tax identification number of the related party; (ii) whether either the taxpayer or the related party sold (or disposed of) property acquired in the exchange within 2 years of the exchange date; and (iii) if the answer to (ii) was “yes”, whether the disposition qualified for an exception by reason of its being as a consequence of the death of either related party, or an involuntary conversion, or its being established “to the satisfaction of the IRS” by “written “explanation” that neither the exchange nor the disposition had tax avoidance as one of its principal

purposes. The instructions add that indirect related party exchanges include (a) an exchange made with a related party through an intermediary (such as a QI or an EAT) or (b) 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.

**F. Summary of Related Party Cases, Rulings, and Advisories**

<b><u>Case, Ruling or Advisory</u></b>	<b><u>QI?</u></b>	<b><u>Basis Shifting?</u></b>	<b><u>Cashing Out?</u></b>	<b><u>(f)(4) Disqual?</u></b>	<b><u>Rationale</u></b>
TAM 9748006	NO	YES	YES	YES	End result same as direct exchange between related parties followed by sale
FSA 199931002	YES	YES	YES	YES	Sale of replacement property acquired through QI from related party w/in 2 years violated (f)(4)
Rev. Rul. 2002-83	YES	YES	YES	YES	Interposition of QI triggered (f)(4), precluding 1031 treatment.
<i>Teruya Brothers</i> (2005; <i>aff'd</i> 2010)	YES	YES	YES	YES	<i>Teruya</i> cashed out its investment. 9 <sup>th</sup> Circuit noted that <i>Teruya</i> could have achieved the same property disposition through “far simpler means.” Presence of QI rendered transaction more complex to avoid 1031(f).
<i>Ocmulgee Fields</i> (2009; <i>aff'd</i> 2010)	YES	YES	YES	YES	Series of transactions “supported inference” that taxpayer had structured transactions to avoid 1031(f)(4). Basis-shifting and reduction in taxes supported “inferences” against taxpayer. Also, “mere existence of legitimate business purpose does not preclude finding the principal purpose for exchange was tax avoidance.
PLR 200616005	YES	YES	PARTIAL	NO	Trust and S Corp. each intended 1031 exchange. related party rules would be inapplicable if 2-year holding period was met.
PLR 200706001	YES	NO	YES	NO	Although exchange of fractional interest in parcel for fee interest in another parcel allowed related party to cash out, no basis shifting.
PLR 200712013	YES	NO	NO	NO	Taxpayer accommodated related party who desired taxpayer’s property by acquiring replacement property. Since related party owned no property prior to exchange, no basis shifting occurred. Since QI was interposed, related party rules were inapplicable. Therefore, 2-year holding period would not apply.
PLR 200919027	YES	YES	YES	NO	Trust, taxpayer and taxpayer’s sibling were co-tenants. Trust wished to cash out. Although taxpayer and taxpayer’s sibling were related, neither intended to sell property within 2 years. Trust was not related.
CCM 20103038	YES	YES	YES	YES	(f)(2)(C) exception to be limited to situations described in legislative history. Other non-tax-avoidance purposes will not cure transaction if any tax avoidance purpose was present.
PLR 201027036	YES	NO	NO	NO	1031(f)(1) inapplicable since QI was interposed. Since no basis shifting occurred, 1031(f)(4) was inapplicable.

**G. Analysis for Related Party Exchanges**

**1. Determine Whether Section 1031(f)(4) May Apply**

If a qualified intermediary is involved in the exchange, first consider the applicability of §1031(f)(4). If §1031(f)(4) is violated by a sale or disposition within two years, the result will be that the transaction will be recharacterized as a taxable sale *ab initio*, rather than a nontaxable exchange. In determining whether the (f)(4) “tax avoidance” provision will result in the transaction failing to constitute an exchange, the IRS looks at (i) basis shifting; (ii) cashing out; and (iii) tax avoidance. If cash “leaves” the group, then the IRS is more likely to assert the applicability of Section 1031(f)(4). If the IRS finds that basis shifting, cashing out or tax avoidance motives are not present, then the existence of the QI may be favorable, since technically no related party exchange will have occurred. Therefore, an early “excepted” disposition (*i.e.*, a disposition within 2 years not having tax avoidance as a principal purpose), should not result in the application of the related party rules, and the denial of exchange treatment.

**a. “Latent” Application of 1031(f)(4) Possible?**

Does the §1031(f)(4) taint remain with the exchange property even if the taxpayer (or the related party) waits 2 years before disposing of the exchange property? It is unclear whether the IRS could invoke §1031(f)(4) to disallow exchange treatment if the taxpayer possesses a tax avoidance motive, but waits two years before disposing of the exchange property. In both *Teruya* and *Ocmulgee*, the taxpayer disposed of the property within two years of the date of the exchange. One could argue that the related party rules have no application after two years. However, the counter argument would be that the two year rule applies to only *related party* exchanges. By interposing a qualified intermediary, the exchange is no longer a related party exchange. Moreover, Section 1031(f)(4) provides that Section 1031 *itself* “shall not apply” to

an exchange “structured to avoid the purposes” of the “this subsection” (*i.e.*, the related party rules). Since the statute of limitations on assessment is three years, it would seem prudent to consider waiting an extra year before disposing of any property acquired through a QI if the IRS could assert the existence of tax avoidance.

## **2. Determine Whether a Prohibited “Disposition” Has Occurred**

If 1031(f)(4) does not apply, then the two year holding period rule will be applicable to the exchange. For example, in PLR 200616005 both related parties (the trust and S Corp.) intended to engage in a Section 1031 exchange. However, if either party disposes of exchange property within two years, the related party rules will become operational, unless the sale or disposition is an “excepted” sale or disposition. Section 1031(f)(2) lists three statutory exceptions: (i) the death of either related party; (ii) an involuntary conversation; or (iii) the lack of a tax avoidance purpose for the exchange or the disposition.<sup>50</sup> If a sale or disposition not falling within an exception occurs within two years, then deferred gain will be recognized at that time. However, unlike the situation arising where subsection (f)(4) takes the entire exchange out of Section 1031, here the exchange will be a good like kind exchange, but deferral will end at the date of the sale or other disposition.

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<sup>50</sup> Examples of exchanges lacking a tax avoidance purpose would be (a) an exchange among related parties which results in fractional interests becoming unitary interests (PLR 200615005; PLR 20091027); (b) where both related parties wish to pursue separate exchanges (PLR 200616005); or (c) where either the taxpayer or a related party acquires property for the purpose of accommodating the desire of a related party to engage in a like kind exchange (PLR 200702013).

### **XIII. 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 often be 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 (9<sup>th</sup> 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 agreed to sell an oil and gas lease for \$2 million. Three months later, the 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 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.

**2. Compare: Taxpayer May Rescind Sale to Pursue Exchange**

It may be possible for a taxpayer who has sold property and then realized his error in not pursuing a like kind exchange, to rescind the contract. Rev. Rul. 80-58 stated that if, for Federal income tax purposes, the rescission of the sale occurred before the end of the taxpayer’s year in which the sale occurs, it would be treated as never having occurred. Rev. Rul. 80-58 describes the legal concept of rescission as the abrogation, canceling, or voiding of a contract that has the effect of releasing the contracting parties from further obligations to each other and restoring the parties to the relative positions that they would have occupied had no contract been made. A rescission may be effected by mutual agreement of the parties, by one of the parties declaring a rescission of the contract without the consent of the other if sufficient grounds exist, or by applying to the court for a decree of rescission.

**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. The Fifth Circuit, in *Swaim v. U.S.*, 651 F.2d 1066 (5<sup>th</sup> Cir. 1981) held that a mere intention to effectuate a tax-free exchange is insufficient. 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 Agency and 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 courts have been lenient in not finding an agency where taxpayer engaged an accommodator to facilitate an exchange. *See Mercantile Exchange Company of Baltimore*, Board of Tax Appeals (1935); *Coupe v. Comr.*, 52 T.C. 394 (1969), *acq.*, 1970-2 C.B. xix. Nevertheless, the risk of employing an accommodator is that the IRS could view the accommodator as the taxpayer’s agent. 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, (1<sup>st</sup> 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.

**b. 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 most of these actions will not 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 unless, as will be discussed *infra*, the transaction is structured under the deferred exchange regulations safe harbor, or the safe harbor for reverse exchanges found in Rev. Proc. 2000-37.

#### **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 QI safe harbor deferred exchange.

### **XIV. 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 F.2d 1341 (9<sup>th</sup> 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 qualified intermediary); 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 (9<sup>th</sup> 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.

#### **4. 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.

#### **5. 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).

#### **6. 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 on either property.

## 7. Four 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 (i) any replacement property received before the end of the identification period (whether or not identified); and (ii) any replacement property *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. “Actual Purchase” Rule**

In TAM 200602034, the taxpayer identified numerous properties whose fair market value exceeded 200 percent of the fair market value of the relinquished property. Thus, neither the “3-property rule” nor the “200 percent rule” could be satisfied. In addition, since the value of the replacement properties ultimately acquired was less than 95 percent of the value of all identified replacement properties, the taxpayer failed the “95 percent” rule. Nevertheless, those properties which the taxpayer

acquired numerous within the 45 day identification period satisfied the “actual purchase rule”. Regs. § 1.1031(k)-1(c)(4)(ii)(A).

## **8. Identification Requirements for Multiple Property Exchanges**

The normal identification rules are applicable for multiple property exchanges. For example, no more than 3 properties may be identified, and the fair market value of identified properties may not exceed 200 percent of the fair market value of relinquished properties.

## **9. 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).

## **10. “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 or to execute a separate contract for the sale of personal property.

## **11. 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

of that date. If compliance with this rule is problematic, it may be possible to fragment the exchange into multiple deferred exchanges.

## **12. 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 1<sup>st</sup>, 2010, he must identify replacement property by August 14<sup>th</sup>, 2010, and acquire all replacement property on or before January 1<sup>st</sup>, 2011, which date is the earlier of (i) January 1<sup>st</sup>, 2011 (180 days after transferring the relinquished property) and October 15<sup>th</sup>, 2011, (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). If, on the other hand, the exchange occurred on November 1<sup>st</sup>, 2010, then the due date of the return (October 15<sup>th</sup>, 2011, with extensions), would be later than April 30<sup>th</sup>, 2011 (*i.e.*, 180 days following the exchange). In this case, the exchange period would terminate on April 30<sup>th</sup>, 2011.<sup>51</sup>

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<sup>51</sup> However, if the taxpayer must request an extension by April 15<sup>th</sup>, 2011. If the taxpayer fails to do so, the exchange would terminate, and the taxpayer would have a right to exchange proceeds held by the QI on April 15<sup>th</sup>, 2011.

**The exchange period is also jurisdictional<sup>52</sup>:** The taxpayer's failure to acquire all replacement property within the prescribed time limit will result in a taxable sale, rather than a like kind exchange. Under these rules, (i) if the exchange occurs fewer than 180 days before the due date of the taxpayer's return without extensions, an extension will be required to extend the exchange period to the full 180-days; and (ii) the exchange period will never be more than 180 days. *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 (9<sup>th</sup> 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 (as in the example above), 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 eventually 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.

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<sup>52</sup> Rev. Proc. 2005-73 provides for a 120 day extension of the 45 day identification period and the 180 day exchange period in the event taxpayer resides in a region which is declared by the President to be a Federal disaster area.

### **3. 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). *Nixon v. Com'r*, T.C. Memo, 1987-318, held that the taxpayer was in constructive receipt of a check payable to taxpayer which the taxpayer did not cash, but later endorsed to a third party in exchange for (intended) replacement property.

**E. Safe Harbors Avoid Problem of Constructive Receipt**

On April 25, 1991, final Regs 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 in the regs. Sensibly, the Regulations also permit *simultaneous exchanges* to be structured under the qualified intermediary safe harbor. While simultaneous exchanges can also be structured outside of the deferred exchange regulations, compliance with the qualified intermediary safe harbor avoids issues of constructive receipt and agency. Note that the qualified intermediary safe harbor is the only deferred exchange safe harbor made applicable to simultaneous exchanges. Regs. § 1.1031(b)-2.

**F. 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) to transfer the replacement property to the taxpayer 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. 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.*

**G. Qualified Escrow or Trust Accounts**

The second safe harbor addresses situations in which exchange funds are segregated in an escrow or trust account. This second 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 will be made without regard to the fact that the 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.*

**1. 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 before the end of 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)(3)(iii).

**2. 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. Persons Related to Taxpayer**

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. Persons Related to Taxpayer’s Agent**

A person who bears a relationship to the taxpayer’s agent 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) is a disqualified person.

**d. Exceptions**

The regulations provide that a person will not be disqualified by reason of its performance of services in connection with the exchange or by reason of its providing “routine financial, title insurance, escrow or trust services for the taxpayer”. Treas. Reg. § 1.1031(k)-1(k). The regulation 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 two years of the date of the exchange.

**H. Qualified Intermediaries**

**The qualified intermediary safe harbor is the most useful of the four safe harbors, as it addresses both agency and constructive receipt concerns.** 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).

**1. Qualified Trust Account & Qualified Intermediary Safe Harbors May Both Be Used in a Single Exchange**

PLR 201030020 corroborated the prevailing view that if all of the safe harbor requirements are satisfied for two safe harbors, both may be utilized in a single exchange. To provide an additional measure of safety to its customer’s exchange funds, bank proposed to hold exchange funds in a qualified trust account pursuant to § 1.1031(k)-1(g)(3)(iii). Bank also proposed serving as a qualified intermediary pursuant to Regs. § 1.1031(k)-1(g)(4). The ruling concluded that “[t]he fact that Applicant serves in both capacities in the same transaction is not a disqualification of either safe harbor

and will not make Applicant a disqualified person.” The Ruling also stated that the bank will not be a “disqualified person” with respect to a customer merely because an entity in the same controlled group performs trustee services for the customer. Finally, the Ruling concluded that a bank merger during the pendency of the exchange would not disqualify it as qualified intermediary for the exchange.

## **2. 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.

## **3. 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, the qualified intermediary safe harbor would require four parties: *i.e.*, the taxpayer, the QI, a cash buyer and a cash seller.

## **4. 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).

## **5. 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.

### **a. 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.

**b. 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).

**6. Protecting Relinquished Property Proceeds**

**a. 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."

**b. 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.

#### **7. 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)." 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)."

#### **8. 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.

## **9. 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.

## **10. 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. Disbursement of Exchange Funds**

#### **1. When Proceeds May be Disbursed**

The taxpayer may receive excess proceeds at the end of the exchange period, whether or not the taxpayer has closed on all properties identified in the identification period.

##### **a. After Relinquished Property Closing but Prior to 46<sup>th</sup> Day**

If the taxpayer has closed on all identified replacement property prior to the 46<sup>th</sup> day, then excess exchange proceeds may be distributed after that time, provided the exchange agreement so permits. 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 46<sup>th</sup> day, provided the exchange agreement so permits.

**b. After the 45<sup>th</sup> Day Identification Period**

If the taxpayer has identified property during the identification period and that property has not been acquired by the end of the identification period, the exchange funds will be frozen with the QI until the 180-day exchange period has expired, or until the taxpayer acquires replacement property. This is true even if the taxpayer decides not to acquire identified replacement property on the 46<sup>th</sup> day. Therefore, if the taxpayer has identified more than one property, and closes on only one property (either before or after the identification period), the remaining exchange proceeds will be frozen with the QI until after the exchange period has ended.

**2. Installment Treatment of Excess Exchange Funds?**

If taxpayer has funds remaining in the exchange account following the identification period (if no identification is made) or at the end of the exchange period (if no or replacement property of lower value is acquired), the remaining exchange funds paid to the taxpayer over time may 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). Those rules protect the taxpayer from constructive receipt of the exchange funds during the exchange period. That “protection” terminates at the end of the exchange period.

**3. Insurance Against Failed Exchange?**

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

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

Prior to the enactment of Section 468B, most taxpayers were not reporting

as income interest or growth attributable to exchange funds held in escrow by qualified intermediaries, and later retained by the QI as a fee. Since the fee paid to the QI is an exchange expense that reduces the amount realized, the IRS believed that this amount was inappropriately escaping income taxation. Accordingly, on July 7, 2008, the IRS issued final Regulations under Section 468B(g) and 7872, which addressed the tax treatment of funds held by qualified intermediaries in various safe harbors provided by Treas. Reg. § 1.1031(k)-1(g). Under the final Regulations, exchange funds are, as a general rule, treated as loaned by the taxpayer to the QI, who takes into account all items of income, deduction and credit. The final Regulations apply to transfers of relinquished property made on or after October 8<sup>th</sup>, 2008. The QI must issue an information return (i.e., Form 1099) to the taxpayer reporting the amount of interest income which the taxpayer earned. Regs. § 1.468B-6(d).

### **1. Imputed Interest on Deemed Loan**

Under Regs. § 1.468B, the taxpayer is treated as the owner of funds held by the QI in an escrow account. The taxpayer is treated as loaning those funds to the QI. The exchange agreement should provide for sufficient interest to be paid. Interest is sufficient if it at least equal to either short-term AFR or the 13-week Treasury bill rate. If sufficient interest is not provided for in the exchange agreement, interest will be imputed under Section 7872<sup>53</sup>. In that case, the QI will be treated as paying interest to the taxpayer on the exchange funds. The taxpayer will then treated as compensating the QI with an amount equal to the deemed interest payment received.

### **2. 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.

### **3. De Minimis Exception**

If exchange funds do not exceed \$2 million and the funds are held for six months or less, no interest will be imputed under Section 7872.

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Section 7872 provides for the tax treatment of below-market loans.

#### **4. Exception: “All of the Income” to Taxpayer**

Another exception provides that if the escrow agreement, trust agreement, or exchange agreement provides that all earnings attributable to the exchange funds are payable to the taxpayer, the exchange funds are not treated as loaned by the taxpayer to the exchange facilitator. In that case, the taxpayer would take into account all items of income, deduction and credit. 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).

#### **5. Divergence of Tax Treatment**

The safe harbor deferred exchange regulations 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.

#### **6. 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 used an interest “surrogate.”

#### **K. 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 funds. Regs. § 1.1031(k)-1(g)(5).

**L. Summary of Deferred Exchange Safe Harbors**

<u>Issue</u>	<u>Security or Guarantee Arrangements</u>	<u>Qualified Escrow or Trust Accounts</u>	<u>Qualified Intermediary</u>
Taxpayer in constructive receipt?	NO. Obligation of transferee may be secured by (i) mortgage; (ii) LC; or (iii) guarantee	NO. Obligation of transferee may be secured by cash or cash equivalent in qualified escrow or trust account	NO. Taxpayer not in constructive receipt of funds held by qualified intermediary
When does constructive receipt protection end?	When taxpayer has immediate ability or right to receive money or property pursuant to agreement	When taxpayer has immediate right to receive, pledge, borrow, or otherwise obtain the benefits of (i) the cash or cash equivalent held by the escrow agent or trustee or (ii) the money or other property held by the QI	
Accommodator agent of taxpayer?	POSSIBLY. Agency is a concern	POSSIBLY. Agency is a concern	NO. Qualified intermediary not considered agent of taxpayer for tax purposes. (But may be agent for other purposes.)
Can be used in three-party exchange?	YES	YES	NO. QI must acquire and transfer exchange properties; therefore, taxpayer, cash buyer, and cash seller are also required.
Can safe harbor be used in simultaneous exchange?	NO	NO	YES
“Disqualified Person”	Not Applicable.	(i) Taxpayer’s agent ( <i>i.e.</i> , employee, accountant, attorney, investment banker or broker, or real estate agent or broker) who provided services within 2 years of the transfer of relinquished property; or (ii) person related to taxpayer under §267(b) or §707(b), determined by substituting “10 percent” for “50 percent” each place it appears; or (iii) a person related to an agent of the taxpayer under §267(b) or §707(b), determined by substituting “10 percent” for “50 percent” each place it appears.	
Exception to Disqualified Person Rule	Not applicable.	Services rendered in connection with 1031 exchange, and routine financial, title insurance, escrow, or trust services for taxpayer by financial institution, title insurance company, or escrow company.	
Subject to “G-6” limitations?	Not applicable.	Yes, escrow, trust, or exchange agreement must limit taxpayer’s right to receive, pledge, borrow, or obtain benefits of money or other property before end of exchange period.	
Permitted “G-7” disbursements	Not applicable.	Taxpayer will not be considered to have received the benefit of (i) items seller receives as a consequence of the disposition of property and that are not included in the amount realized ( <i>e.g.</i> , real estate taxes); and (ii) transactional items (typical closing costs) that relate to the disposition of the relinquished property or the acquisition of the replacement property ( <i>e.g.</i> , commissions, transfer taxes, recording fees).	
Status of other disbursements made by trustee, escrow agent, or QI	Not applicable.	Other disbursements made by the QI (or by the Trustee or Escrow Agent) to persons other than the taxpayer would not destroy the safe harbor, but would constitute boot. <b>Disbursements made directly to the taxpayer would destroy the safe harbor.</b>	

**M. Traps for the Unwary****1. Exchange Agreement Must Contain Limitations**

The exchange 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. In *Hillyer v. Com'r*, TC Memo 1996-214, the Tax Court denied exchange treatment and held a taxable sale occurred where the exchange agreement failed to contain restrictions on the taxpayer's right to constructive receipt of the proceeds pursuant to Regs. § 1.1031(k)-1(g)(6). *Florida Industries Investment Corp. v. Com'r*, 252 F.3d 440 (11<sup>th</sup> Cir. 2001) held that where the qualified intermediary was under the control of the taxpayer, the taxpayer had "effective control" of all escrow funds.

**2. Exchange Agreement May Allow Taxpayer Access to Exchange Proceeds in Limited Circumstances**

Regs. § 1.1031(k)-1(g)(6) provides several rules which permit the exchange agreement to modify the time when the taxpayer has access to exchange proceeds.

**a. No Identification of Replacement Property By End of Identification Period**

If the taxpayer fails to identify any replacement property by the end of the identification period, the exchange agreement may provide that the taxpayer has access to exchange funds after the 45-day identification period. Regs. § 1.1031(k)-1(g)(6)(ii).

**b. Receipt of all Identified Property Prior to End of Exchange Period**

If the taxpayer receives all identified property prior to the end of the exchange period, the exchange agreement may provide that the taxpayer has access to exchange funds at that time. Regs. § 1.1031(k)-1(g)(6)(iii)(A). Therefore, if the taxpayer intends to close on one property, but

identifies multiple properties as potential “backup” properties, the taxpayer may have to wait until end of the 180-day exchange period to demand the balance of exchange proceeds held by the QI.

**c. Occurrence of a “Material and Substantial”  
Contingency Affecting Exchange**

The exchange agreement may provide that if an unexpected contingency identified in the exchange agreement causes the exchange go to awry, the taxpayer may have access to exchange funds prior to the end of the exchange period. Thus, 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. Regs. § 1.1031(k)-1(g)(6)(iii)(B).

**3. Modification of Exchange Agreements**

PLR 200027028 held that exchange agreements could be modified to allow for early distribution of cash where taxpayer was unable to reach a contract with the seller of replacement property.

**4. Boot Paid By QI to Taxpayer Destroys Safe Harbor**

Money or other property paid to the taxpayer by another party to the exchange will constitute boot, but will not destroy the safe harbor. Treas. Regs. § 1.1031(k)-1(g)(4)(vii). However, the payment to the taxpayer 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).

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

**1. Exchange Funds Could be Considered “Payment”**

To benefit from installment reporting, the taxpayer must avoid the receipt of “payment” in the taxable year of the disposition. Under the installment sale rules, a seller is deemed to receive payment when cash or

cash equivalents are placed in escrow to secure payment of the sales price. Temp. Regs. § 15A.453-1(b)(3)(i). The regulations further provide 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. Accordingly, 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).

## **2. Deferred Exchange Regs Trump Installment Sale Regs**

Fortunately, the safe harbor deferred regulations, 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. Thus, Treas. Reg. § 1.1031(k)-1(j)(2) provides that a transferor is not deemed to have received an installment payment under a qualified escrow account or qualified trust arrangement, nor is the receipt of cash held in an escrow account by a qualified intermediary treated as a payment to the transferor under the rules, provided the following two conditions are met: (i) the taxpayer has a “*bona fide* intent” to enter into a deferred exchange at the beginning of the exchange period and (ii) the relinquished property does not constitute “disqualified” property. *See* Temp. Reg. § 15A.453-1(b)(3)(i). Treas. Reg. § 1.1031(k)-1(k)(2)(iv) states that a taxpayer possesses a *bona fide* intent to engage in an exchange only if it is 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.

## **3. Effect of Satisfying “Intent” Requirement**

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). However, the relief from the otherwise operative installment sales regulations ceases upon the earlier of (i) the end of the exchange period or (ii) the time when the taxpayer has an immediate right to receive, pledge, borrow, or otherwise obtain the benefits of the cash or the cash equivalent. Treas. Reg. § 1.453-1(f)(1)(iii). At that time, the taxpayer will be considered to be in receipt of “payment”.

#### 4. Illustration of Installment Sale Rules in Deferred Exchange

##### a. Taxpayer Relinquishes Property in Anticipated Exchange with Funds Held by QI

On December 1<sup>st</sup>, 2010, 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.

##### b. QI Transfers Replacement Property to Taxpayer Completing Exchange

On January 1<sup>st</sup>, 2011, 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. The taxpayer is treated as having received payment on January 1<sup>st</sup>, 2011, rather than on December 1<sup>st</sup>, 2010. If the other requirements of Sections 453 and 453A are satisfied, the taxpayer may report the gain under the installment method.

##### c. Outcome if QI Had Failed to Identify Replacement Property

If the QI failed to identify replacement property by January 15<sup>th</sup>, 2011 (the end of the identification period) and distributed \$50 billion in cash to taxpayer, under Regs. § 1.1031(k)-1(j)(2)(iv) the taxpayer could still report gain using the installment method, since the taxpayer had a *bona fide* intent at the beginning of the exchange period to effectuate a like kind exchange. (The same logic would apply if the taxpayer had identified replacement property

but had failed to close on the replacement property by May 30<sup>th</sup>, 2011, the end of the exchange period.)

**d. Effect of California “Clawback” Rule on Exchange**

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 (8.97 percent<sup>54</sup>) 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.

**5. Inadvertent Opt-Out of 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 one, 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.

**O. 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

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<sup>54</sup> 6.85 percent for income between \$20,000 and \$200,000; 7.85 percent on income above \$200,000; 8.97 percent on income above \$500,000.

following a disposition equals that percentage of the payments received, which the gross profit bears to the total contract price. Consequently, if a taxpayer sells real estate with a basis of \$500,000 for \$1 million, 50 percent of payments (*i.e.*, gross profit/total contract price) received would be taxable as gross income. Gain recognized in a like kind exchange may be eligible for installment treatment if the taxpayer otherwise qualifies to use the installment method to report gain.

## **2. Timing of Reporting Installment Gain in Exchange**

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.” However, the Temporary Regulations provide that the term “payment” includes amounts actually or constructively received under an installment obligation. Therefore, the receipt of an installment obligation in a like kind exchange would constitute boot. Prop. Reg. § 1.453-1(f)(1)(iii) provides for the timing of gain upon receipt of an installment obligation received in a like kind exchange. Installment notes (which qualify for installment reporting) received in a like kind exchange would not be taxed as the time of the exchange. Rather, as payments are received on the installment obligation, a portion of each payment would be taxed as gain, and a portion would constitute a recovery of basis.

### **a. Method of Allocating Basis to Installment Note**

The Regulations generally allocate basis in the transferred property entirely to like kind property received in the exchange where an installment obligation is received. The result is that less basis is allocated to the installment obligation. This is disadvantageous from a tax standpoint, since a greater portion of each payment received under the installment obligation will be subject to current tax.

### **b. Illustration**

Taxpayer exchanges property with a basis of \$500,000 and a fair market value of \$1 million for like kind exchange property worth \$750,000 and an installment obligation of \$250,000. The installment note would constitute boot, but would be eligible for reporting under the installment method. Under the Proposed Regulations, the entire \$500,000 basis would be allocated to the like kind replacement property received in the exchange. No basis

would be allocated to the installment obligation. Consequently, 100 percent of all principal payments made under 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.*,  $1/4 \times \$500,000$ ). In that case, 50 percent ( $\$125,000/\$250,000$ ) 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 was later sold.

**P. Structuring Down Payment**

**1. Relinquished Property Deposit**

**a. Deposit Before Contract Assigned to QI**

Any deposit held by the taxpayer's attorney should be assigned (along with all of the taxpayer's rights in the relinquished property contract) to the QI. The taxpayer's attorney could also (i) refund the deposit to the purchaser prior to closing, and request that the purchaser cut a check directly to the QI; or (ii) refund the deposit to the purchaser at closing, and increase the purchase price to reflect the refund; or since the attorney is an escrow agent, (iii) release the deposit to the QI at closing.

**b. Deposit Made After Assignment to QI**

If no deposit has been made before the purchase contract has been assigned to the QI, the deposit should be paid directly to the QI.

**c. Deposit Made to Taxpayer Directly**

If the taxpayer contemplates pursuing a like kind exchange, no deposit should be paid to the taxpayer directly. However, if this is a *fait accompli*, the taxpayer should remit the funds as soon as possible to the QI, or, if no QI has been engaged, to the taxpayer's attorney.

## 2. Replacement Property Deposit

### a. Deposit Made by Taxpayer

If the taxpayer is in contract for the purchase of the replacement property before the QI is engaged, the taxpayer will have made the deposit with his own funds. *It would clearly violate the deferred exchange “G-6” limitations if the QI reimburses the taxpayer for the deposit prior to closing from exchange funds.* However, at closing, the QI could reimburse the taxpayer from the exchange funds. The seller could also refund the deposit the taxpayer at closing, with the QI providing a replacement check.

### b. Deposit Made by QI

The QI may make a deposit for replacement property only after the purchase agreement for the replacement property has been assigned the QI. The escrow instructions should provide that if the taxpayer does not close on the property, or if the contract is terminated for any reason, the deposit will be returned to the QI, and not the taxpayer.

## Q. Issues Involving Qualified Intermediaries

### 1. LandAmerica Collapse

LandAmerica 1031 Exchange Services Company, Inc., a qualified intermediary, invested exchange funds in auction rate securities that became illiquid in 2008. LandAmerica was unable to sell or borrow against those securities, and was forced to seek bankruptcy protection. Because the exchange proceeds were frozen, clients in the midst of an exchange were unable to complete their exchanges within the exchange period. Consequently, those taxpayers’ contemplated exchanges turned into taxable sales. Since the exchange proceeds were frozen in bankruptcy proceedings, those taxpayers were deprived of the sale proceeds with which to satisfy those tax liabilities. Fortunately, the IRS provided relief in Rev. Proc. 2010-14.

### a. **Rev. Proc 2010-14 – Installment Method for Failed Exchanges**

Rev. Proc. 2010-14 provides guidance concerning a

failed exchange caused by the collapse or bankruptcy of a QI. In this situation, the taxpayer will be unable to access the funds received by the QI from the relinquished property sale during the pendency of bankruptcy or receivership proceedings. While Rev. Proc. 2010-14 does not rehabilitate the failed exchange, it recognizes that the taxpayer “should not be required to recognize gain from the failed exchange until the taxable year in which the taxpayer receives a payment attributable to the relinquished property.” Accordingly, the taxpayer is put on the installment method of reporting gain, and “need recognize gain on the disposition of the relinquished property only as required under the safe harbor gross profit ratio method.”

## **2. Danger of QI Commingling Exchange Funds**

*In Nation-Wide Exchange Services*, 291 B.R. 131, 91 A.F.T.R. 2d (March 31, 2003), the qualified intermediary commingled exchange funds in a brokerage account and sustained significant losses. The Bankruptcy Court found that the failure of Nation-Wide to use segregated accounts effectively converted customer deposits to property of Nation-Wide for purposes of bankruptcy law. All disbursements made by Nation-Wide in the 90 days preceding its bankruptcy were returned to the bankruptcy trustee.

## **3. 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, including LandAmerica, in 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. A few states, including Nevada and California, regulate qualified intermediaries. Under California 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.

**R. 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 contingent 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 that the intermediary (iv) 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 the 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 (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, or to all 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 (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.

## **7. Settlement Statement**

The closing statement (and HUD-1) should indicate that exchange proceeds were paid to the qualified intermediary. Any fees and expenses paid by the QI will be itemized on the Settlement Statement.

# **XV. 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.<sup>55</sup> In a reverse exchange, 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, *Bezdirjan v. Com'r*, 845 F.2d 217 (9<sup>th</sup> 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 *Bezdirjan*, taxpayers began engaging in a variety of

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See Preamble to final Regulations, 56 Red. Reg. 19933 (5/1/91).

“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”). Just as deferred exchanges were recognized by courts, so too, reverse exchanges soon received a judicial imprimatur.<sup>56</sup>

### **1. Rationale for Engaging in Reverse Exchange**

One situation calling for a reverse exchange might arise where the purchaser of the taxpayer’s relinquished has defaulted, leaving the taxpayer in a position of either closing on the replacement property or forfeiting his down payment. Another would be where the taxpayer needs to take title to the replacement property – for whatever reason (*e.g.*, competition for property or need to improve property) before locating a suitable property to relinquish in the exchange.

### **2. Reverse Exchanges May be Costly**

The requirement that the EAT obtain legal title to the parked property makes reverse exchanges relatively costly, since additional transfer tax liability may be incurred. Accordingly, reverse exchanges should be used only when a deferred exchange is impossible, such as where the purchaser of the relinquished property has defaulted, or where title must be taken to the replacement property immediately, before the taxpayer disposes of relinquished property.

## **B. Two Types of Reverse Exchanges**

The two types of reverse exchanges consist of (i) “Non-safe harbor” (or “pure”) reverse exchanges and (ii) reverse exchanges structured under Rev. Proc. 2000-37. Non safe harbor reverse exchanges have no identification or exchange period requirements *per se*. Although the Rev. Proc. 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 a problem. If so, a non safe harbor reverse exchange may be the only option.

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<sup>56</sup> In theory, the IRS could argue that the accommodator is acting as the taxpayer’s agent, with the taxpayer being in constructive receipt of the exchange funds. 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. Overview of Revenue Procedure**  
**2000-37 Safe Harbor Reverse Exchange**

Rev. Proc. 2000-37 permits taxpayers intending to complete a like-kind exchange after acquiring replacement property to accomplish that result in a predictable fashion. 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.

**1. Many Requirements Imposed by Rev. Proc. 2000-37 Borrowed From Deferred Exchange Regulations**

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. Thus, the 45-day identification 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-day exchange period limits the time in which an EAT may hold and improve replacement property in an Exchange Last reverse exchange. The 180-day period also limits the time in which the EAT may hold relinquished property for sale in an “Exchange First” reverse Exchange.

**2. EAT Must be Tax Owner of Parked Property**

Under Rev. Proc. 2000-37, the EAT is must be 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). Rev. Proc. 2000-37 is effective with respect to an EAT that acquires legal or beneficial title on or after September 15, 2000.

**3. 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 arrangement” (QEAA). The “qualified exchange accommodation agreement” (also QEAA) will provide that the EAT is not the taxpayer’s agent for federal

tax purposes.

#### **4. Qualified Exchange Accommodation Arrangement**

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

##### **a. 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 date 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 the property. Although the EAT must possess beneficial title, the EAT need not either acquire any equity interest or assume any risk.<sup>57</sup> The EAT cannot be either the taxpayer or a “disqualified person.” The EAT must be subject to and report federal income tax.

##### **b. 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 (iii) a person who bears a relationship described in (ii) to the agent of the taxpayer. Essentially, the rules parallel the rules for persons who are disqualified from acting as qualified intermediaries under the deferred exchange Regulations.

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<sup>57</sup> 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 percent and up to 20 percent of the cost of the replacement property. Contractual relationships between the accommodation party and the taxpayer were required to be at 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.

**c. Services of EAT Not Taken Into Account**

Services provided to 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 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.

**d. 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.

**e. Qualified Agreement with EAT**

No later than five business days after the transfer of QIO to the EAT, the taxpayer and the EAT must enter into the "qualified exchange accommodation agreement" (QEAA) stating that (i) the EAT is holding the property for the benefit of the taxpayer to facilitate an exchange under Section 1031 and Rev. Proc. 2000-37; (ii) the parties agree to report the acquisition, holding, and disposition of the property as provided for therein; (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.

**f. 45-Day Period to Identify Relinquished Property**

No later than 45 days after the transfer of QIO to the EAT, the relinquished property (in an exchange last exchange) 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 for in Regs. § 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 45<sup>th</sup> day following acquisition of replacement property.<sup>58</sup> [Note: The identification requirement would, by definition, have no application in an exchange first reverse exchange, where the taxpayer sells relinquished property to the EAT at the outset.]

**g. 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 cash buyer (other than the taxpayer or a disqualified person) as relinquished property (“exchange first” format).

**h. 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.

**5. Summary of Requirements for Property Deemed to be Held in QEAA**

- a. EAT must have Qualified Indicia of Ownership (QIO);
- b. EAT cannot be taxpayer or disqualified person;
- c. EAT must be subject to and report federal tax;
- d. Taxpayer must intend exchange when QIO is transferred to EAT;
- e. Taxpayer must enter into “Qualified Exchange Accommodation Agreement” with EAT within five days of transfer of QIO to EAT;
- f. No later than 45 days after transfer of QIO to EAT, taxpayer must identify property to be relinquished in an exchange last reverse exchange;
- g. No later than 180 days after transfer of legal title to EAT, (i) replacement property must be transferred by EAT through QI to taxpayer (exchange last); or (ii) relinquished property must be transferred by EAT to cash buyer

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<sup>58</sup> Unlike deferred exchanges involving a QI, the taxpayer cannot assume that the identification requirement will be satisfied by the actual acquisition of replacement property within 45 days, unless the EAT is notified. The EAT in an “exchange last” reverse exchange may be “outside the loop”. The EAT in an exchange last reverse exchange will be parking the replacement property which it acquired at the outset. The QI in such an exchange will be acquiring replacement property directly through the qualified intermediary. 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 notified.

(exchange first);

- h. Combined time period during which relinquished and replacement property may be held in QEAA cannot exceed 180 days.

## **6. 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.

### **a. EAT May Be QI**

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 for the sale of the relinquished property.

### **b. Taxpayer May Guarantee Obligations of EAT**

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

### **c. Taxpayer or Disqualified Person May Loan Funds 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.

### **d. EAT May Lease Property to Taxpayer or Other Disqualified Person**

The EAT may lease property to the taxpayer or to a disqualified person. Rev. Proc. 2000-37 imposes no requirement that 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.

**e. 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 may be responsible for improvements being made.

**f. Taxpayer and EAT May Arrange 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 the property, provided they are effective for not more than 185 days from the date the property is acquired by the EAT.

**g. “Make Whole” Provision May be Agreed Upon**

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 address this contingency, the QEAA may permit the taxpayer and the EAT to enter into agreements and arrangements providing that any variation in the value of relinquished property be taken into account upon the EAT’s disposition of the relinquished property.

**h. 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. Thus, although the EAT must be the owner for federal income tax purposes, it need not be the owner for

other purposes.

## **7. Summary of Permissible Agreements Between EAT and Taxpayer**

- a. EAT may be QI;
- b. Taxpayer or disqualified person may guarantee obligations of EAT;
- c. Taxpayer or disqualified person may loan funds to EAT;
- d. EAT may lease property to taxpayer or other disqualified person;
- e. Taxpayer or other disqualified person may manage property;
- f. Taxpayer and EAT may enter into contracts (including puts and calls) regarding the purchase and sale of property, provided contract is not effective for more than 185 days after EAT acquires property;
- g. EAT and taxpayer may enter into contracts that take into account variation in value of relinquished property upon disposition by EAT;
- h. Although EAT is owner for federal income tax purposes, tax treatment of EAT may differ for regulatory, state or local tax treatment.

## **8. 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 transfer tax purposes.

## **9. Distinguish Qualified Intermediary (QI) and EAT**

The role of a QI is distinguishable from that of the EAT in that the QI will rarely acquire record title in exchange property<sup>59</sup> while the EAT will always acquire title in either the relinquished or the replacement property. The EAT must be the "tax owner" of the property with respect to which record title is acquired, a requirement not imposed on the QI. Through the use of legal fictions, both Rev. Proc. 2000-37 and deferred exchange Regs. § 1.1031(k)-1(g)(3) liberate the taxpayer from concerns that the IRS will deem the taxpayer to be in constructive receipt of exchange funds, or will deem the QI or the EAT to be the taxpayer's agent for federal tax purposes, either of which would imperil the exchange. Helpfully, both the QI and the EAT may be the taxpayer's designated agent for other legal purposes and for local (*i.e.*, transfer tax) purposes without impairing exchange treatment,

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<sup>59</sup> A qualified intermediary might acquire title if the qualified intermediary was engaged to improve the replacement property during the 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.

although the EAT may have difficulty establishing that it is not liable for transfer tax). This difficulty arises because despite the EAT, although holding only “bare legal title,” is also the “tax owner” for federal income tax purposes. The QI does not face this quandary, since the QI will rarely if ever acquire record title to exchange property and will even more rarely acquire any beneficial interest in the exchange property. Nor will the QI ever be the “tax owner” for federal tax purposes. Although federal tax law treats the EAT and the QI benignly for federal tax purposes, local law may be unimpressed with Rev. Proc. 2000-37, and may insist on payment of transfer tax before recording any exchange transaction deed.

#### **D. Non Safe Harbor Reverse Exchanges**

Rev. Proc. 2000-37 states that reverse exchanges may be consummated outside of the safe harbor. Still, Rev. Proc. 2000-37 reflects the philosophy of the IRS with respect to reverse exchanges and accordingly, many companies operating as Exchange Accommodation Titleholders will only structure reverse exchanges within the parameters of Rev. Proc. 2000-37.<sup>60</sup> Presumably, case law and rulings predating Rev. Proc. 2000-37 are relevant in resolving issues arising in connection with reverse exchanges.

##### **1. Rev. Proc. 2000-37 Cannot Accommodate Improvements Requiring More than 180 Days**

If it is necessary to go beyond 180 days (or if the EAT is a “disqualified person”) the taxpayer can still pursue “non-safe-harbor” or “pure” reverse exchange. Non safe harbor reverse exchanges free the taxpayer of the 180-day limit that the EAT may hold qualified indicia of ownership (QIO) in exchange property. However, pure reverse exchanges pose more tax risk, as they are burdened with issues of agency, constructive receipt and beneficial ownership. Tax risk reaches its zenith when the taxpayer attempts to converting a safe harbor reverse exchange into a non safe harbor reverse exchange. If improvements can be completed within the 180-day period in which the property is parked with the EAT, Rev. Proc. 2000-37 provides a degree of certainty. However, if it is necessary to go beyond 180 days (or if the EAT would be a disqualified person) the taxpayer wishing to complete a like kind exchange may become relegated to pursuing a non safe harbor or

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<sup>60</sup> While the presence of an accommodator would be necessary in a non safe harbor reverse exchange, that accommodator would not be an EAT, since an EAT is a creature of Rev. Proc. 2000-37, and only lives within its parameters.

“pure” reverse exchange.<sup>61</sup>

## **2. Stringent Disqualification Rules Have No Application in Non Safe Harbor Reverse Exchanges**

The stringent disqualification rules found in Rev. Proc. 2000-37 are absent in non safe harbor reverse exchanges. Rev. Proc. 2000-37, as well as the deferred exchange regulations, which substitute “10 percent” for “50 percent” under Sections 267(b) and 707(b) in determining whether a person is a disqualified person, have no application in a non safe harbor reverse exchange.<sup>62</sup>

## **3. Issues of Agency and Constructive Receipt Present in Non Safe Harbor Reverse Exchanges**

Liberties taken when the exchange was planned under the safe harbor reverse exchange under Rev. Proc. 2000-37 may doom the non safe harbor reverse exchange. This is because issues of agency and constructive receipt, which were protected by the safe harbor, will lose their protection in a non safe harbor reverse exchange. Many of the permissible arrangements under Rev. Proc. 2000-37 would cause a non-safe harbor reverse exchange to violate agency or constructive receipt rules governing like kind exchanges. Stripped of the safe harbor protection of Rev. Proc. 2000-37, the IRS could argue that the EAT was the taxpayer’s agent. The success of a pure reverse exchange will therefore depend in substantial part upon whether the accommodator is respected as tax owner, or is deemed to be merely the taxpayer’s agent. As a practical matter, non-safe harbor qualification may prove difficult if the transaction was originally intended to qualify under Rev. Proc. 2000-37.

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<sup>61</sup> Section 3.02 of the Rev. Proc. 2000-37 explicitly 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.” Moreover, PLR 200111025 recognized that non-safe-harbor reverse exchanges survive Revenue Procedure 2000-37.

<sup>62</sup> However, non-safe-harbor reverse exchanges would still be subject to the related party rules themselves, albeit without varying the “50 percent” language found Sections 267(b) and 707(b).

**E. Comparison of Function of Exchange  
Accommodation Titleholder (EAT) to Qualified Intermediary (QI)**

	<u>Legal Title?</u>	<u>Beneficial Title?</u>	<u>Desired Agent for Legal or Tax?</u>	<u>Escrow Agent?</u>	<u>Constructive Receipt of Exchange Funds?</u>	<u>Applicability of 45-day Limit</u>	<u>Applicability of 180-day Limit</u>
EAT	Yes, always <sup>63</sup>	Tax Owner (QIO) <sup>67</sup>	Transfer tax <sup>64</sup> and perhaps legal <sup>68</sup> but not federal tax	Yes	Safe harbor avoids <sup>65</sup>	In Exchange Last, identify relinquished property. None in Exchange First.	See footnote <sup>66</sup>
QI	Not required to, but may <sup>71</sup>	Never	Transfer tax, <sup>69</sup> and perhaps legal <sup>72</sup> but not federal tax	Yes	Safe harbor avoids <sup>70</sup>	Must identify replacement property	Must acquire replacement property

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<sup>63</sup> In either the relinquished (exchange first) or replacement (exchange last) property.

<sup>64</sup> Since EAT acquires only “bare legal title,” QEAA would treat EAT as taxpayer’s agent for transfer tax and state and local tax purposes. However, since EAT possesses QIO, may be difficult to argue.

<sup>65</sup> If reverse exchange is structured outside of safe harbor, constructive receipt may pose problem.

<sup>66</sup> In Exchange First, EAT must dispose of relinquished property within 180 days after acquiring QIO. In Exchange Last, EAT acquires replacement property at outset, and must transfer property to taxpayer through QI within 180 days after acquiring QIO. QI will use funds to purchase replacement property being held by EAT. Time limits have no (formal) applicability in non-safe-harbor reverse exchanges.

<sup>67</sup> The EAT must acquire “qualified indicia of ownership” (QIO) in either the relinquished or replacement property, which means bare legal title. No actual equity interest required. As tax owner, EAT is subject to and must report federal income tax. EAT not required to be legal owner for other purposes.

<sup>68</sup> EAT may act as taxpayer’s agent for other legal purposes, and QEAA may so provide.

<sup>69</sup> For transfer tax purposes, QI is agent of taxpayer. However, for other legal purposes, QI not required to be taxpayer’s agent.

<sup>70</sup> Only safe harbor for qualified intermediaries avoids issue of constructive receipt.

<sup>71</sup> Safe harbor permits direct deeding of properties, permitting QI to avoid possessing legal title. QI would typically acquire legal title if improvements were to be made during the 180-day exchange period. However, 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.

<sup>72</sup> As with EAT, QA may act as taxpayer’s agent for other legal purposes. For example, taxpayer may be concerned about bankruptcy of QI; or QI may be concerned with taking title to property that may be burdened with possible claims.

**F. Summary of Exchange First Format**

In an Exchange First reverse exchange, the EAT purchases the relinquished property from the taxpayer through the QI. The purchase price may be financed by the taxpayer. Using exchange funds obtained from the EAT, the QI purchases replacement property which is transferred to the taxpayer, completing the exchange. The EAT may continue to hold the relinquished property for up to 180 days after acquiring QIO. During this 180-day period, the taxpayer will arrange for a buyer. At closing, the EAT will use funds derived from the sale of the relinquished property to retire the debt incurred by the EAT in purchasing the relinquished property from the taxpayer at the outset.

**1. EAT Never Acquires Ownership in Replacement Property**

Since the replacement property is transferred directly by the QI to the taxpayer, the EAT never acquires ownership in the replacement property. Therefore, the EAT need not be involved in the loan process, and also need not take title to the replacement property, 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 obtained by the EAT to purchase the relinquished property.

**2. When Exchange First Reverse Exchange Desirable**

An Exchange First reverse exchange may be desirable if the intended purchaser of the relinquished property has defaulted, leaving the taxpayer obligated to close on the replacement property or risk losing his deposit. If management problems exist, it may also be preferable for the taxpayer to take immediate ownership in the replacement property. By parking the relinquished property with the EAT, the taxpayer can acquire the replacement property before finding a new buyer for the relinquished property. The taxpayer must park the relinquished property with the EAT at the outset, since the QI must have the proceeds from the sale of the relinquished property to the EAT to close on the replacement property. Accordingly, the only applicable time limitation in a safe harbor Exchange First reverse exchange is the 180-day period within which the EAT must dispose of the parked relinquished property.

**G. Summary of Exchange Last Format**

In an Exchange Last reverse exchange, the EAT takes title to (*i.e.*, acquires “QIO”) and “parks” replacement property at the outset. Financing for the purchase may be arranged

by the taxpayer. The EAT may hold title to the replacement property no longer than 180 days after it acquires QIO. While parked with the EAT, the property may be improved, net-leased, or managed by the taxpayer. During the period in which the replacement property is parked with the EAT, the taxpayer will arrange to dispose it through a QI. The taxpayer must identify property (or properties) to be relinquished within 45 days of the EAT acquiring title (QIO) to the replacement property, and must dispose of the relinquished property (through the QI) within 180 days of the EAT acquiring title (QIO). Following the sale of the relinquished property to a cash buyer through a QI, the QI will transfers those proceeds to the EAT in exchange for the parked replacement property. The EAT will direct-deed the replacement property to the taxpayer, completing the exchange. The EAT will use the cash received from the QI to retire the debt incurred in purchasing the replacement property.

#### **H. Typical Steps in Exchange Last Reverse Exchange**

1. The EAT creates a SMLLC to hold title to the replacement property which it will acquire pursuant to the Qualified Exchange Accommodation Agreement (QEAA) with the taxpayer. The QEAA provides that the taxpayer will assign to the EAT all contractual rights to purchase the replacement property. Financing for the purchase will be provided by the taxpayer or by the seller of the replacement property, or by the EAT itself. The QEAA must provide that the EAT may hold the replacement property for a period not exceeding 180 days after acquiring title (QIO).
2. After acquiring the replacement property, the EAT may 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. During the 180-day period in which the EAT parks the replacement property, the EAT may make improvements financed by the taxpayer and made under the direction of the taxpayer.
3. The taxpayer must identify property to be relinquished within 45 days of the date when the EAT acquires QIO to the replacement property. The identification follows the normal identification rules (*e.g.*, 3-property rule, 200 percent rule). The taxpayer must acquire title to the replacement property within 180 days after the EAT acquires QIO to the replacement property.
4. The QI will cause the relinquished property to be sold, with the taxpayer direct-deeding title to the relinquished property to the purchaser. The proceeds from the relinquished property sale by the QI will be used first to pay costs of the sale (transfer and recording fees and taxes, title insurance, etc.). Pursuant to the QEAA, the EAT will sell the replacement property to the QI in exchange for funds held by the QI from the sale of the relinquished property. The EAT will direct deed title to the replacement property to the taxpayer, completing the exchange. While the EAT is not

a party to the exchange agreement between the taxpayer and the QI, the EAT may also serve as QI.

5. The EAT will use the proceeds of the sale to satisfy any indebtedness incurred by the EAT in purchasing the replacement property. If the net proceeds are insufficient, the taxpayer will provide additional funds to the EAT. If net proceeds remain, that remaining cash may be used by the taxpayer to acquire other like kind exchange property in a forward deferred exchange, subject to the 45-day identification and 180-day deferred exchange requirements. *See* CCA 200836024.

6. **Advantages of Exchange Last**

Since the parked property will have been initially acquired by the EAT, there is little risk the EAT will be disregarded for tax purposes. In addition, following acquisition by the EAT of the replacement property, the taxpayer can consider several potential properties to be relinquished, and can ultimately choose that which defers the most gain. The taxpayer must identify potential properties to be relinquished within the 45-day identification period and must close within 180 days. A build-to-suit reverse exchange would by definition always employ the exchange last format.<sup>73</sup> While parked with the EAT, the property may be improved. If improvements cannot be completed within 180 days, a reverse exchange would not be structured under Rev. Proc. 2000-37.

a. **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 advise the lender at an early stage of the planned reverse exchange and the presence of the EAT.

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<sup>73</sup> In the exchange first format the EAT can always acquire relinquished property and never acquire replacement property.

## I. Comparison of Exchange Last and Exchange First Reverse Exchanges

	Time taxpayer acquires replacement <u>property</u>	<u>EAT Acquisition</u>	<u>Role of EAT</u>	Build to-suit <u>possible?</u>	<u>Advantages</u>	<u>Disadvantages</u>	<u>Typical Use</u>
Exchange First	At outset	Relinquished property only at outset from taxpayer	Park relinquished property until disposition within 180 days of acquiring QIO	NO	(i) EAT not involved in loan for replacement property; (ii) Replacement Property may be used as collateral for loan; (iii) immediate ownership; (iv) Taxpayer has time to locate replacement property w/o pressure of 45-day identification period	(i) Loss of flexibility w/r/t choosing relinquished property; (ii) transfer tax cost	Buyer defaults and taxpayer must take title to replacement property or risk losing downpayment
Exchange Last	Following 45-day identification, and within 180-day exchange period	Replacement property only at outset from cash seller	Park replacement property until taxpayer acquisition through QI within 180 days of EAT acquiring QIO.	YES <sup>74</sup>	(i) taxpayer has time to choose relinquished properties; (ii) EAT title owner (iii) can fall back to non-safe harbor reverse exchange; (iv) can combine w/deferred Exchange.	(i) Typically, not much advantage over garden variety deferred exchange w/ QI engaged to construct improvements; (ii) transfer tax cost	Build-to suit where no time to arrange for disposition of relinquished property, so typical deferred exchange with QI not feasible

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If improvements not possible within 180 days, taxpayer can pursue non-safe-harbor reverse exchange.

## **J. Cases and Rulings Involving Reverse Exchanges**

### **1. The “Unplanned Reverse Exchange” – TAM 200039005**

In TAM 200039005, a 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 an accommodator, who 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 in the replacement property to the taxpayer and transferred title 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 the accommodator at the time replacement property was acquired from the cash seller. The transaction also reflected a lack of intent to effectuate an exchange, since the cash buyer was not part of the transaction when the accommodator acquired title to the replacement property.

**c. 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, the taxpayer's position would have been strengthened had an exchange agreement been entered into with the cash seller prior to the initial closing.

**d. 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 Rev. Proc. 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 construction 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, 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. In addition, 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 deemed never to be 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 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 the 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) unless the transaction is structured as a reverse exchange under Rev. Proc. 2000-37; 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**

a. **Exchange Last Reverse Exchange**

In CCA 200836024 the taxpayer, pursuant to Rev. Proc. 2000-37, structured an “exchange last” reverse exchange and a deferred exchange. In an exchange last reverse exchange, Greenacre was acquired by the EAT as replacement property and parked until the taxpayer identified property to be relinquished. Thirty-three days after Greenacre was acquired by the EAT, the taxpayer identified three alternative properties to be relinquished, Redacre being one. On the 180<sup>th</sup> day following the EAT’s acquisition of Greenacre, Redacre was relinquished, and the reverse exchange was unwound through the QI.

b. **Problem of Boot**

Since the value of Redacre far exceeded the value of Greenacre, the taxpayer would have significant boot in the exchange. To remedy this, the taxpayer proposed to engage in a second exchange to defer the remaining gain, by treating the sale of Redacre as the relinquished property in a deferred exchange. Accordingly, 42 days after the sale of Redacre, the taxpayer identified three additional properties, as potential replacement properties in connection with the relinquishment of Redacre.

c. **May the Same Relinquished Property Be Used For Both a Reverse and Deferred Exchange?**

The issue was whether the taxpayer could utilize the same property as relinquished property in an exchange last reverse exchange and then as relinquished property in a

deferred exchange. Reasoning that the taxpayer had complied with identification requirements for both reverse and deferred exchanges, the advice concluded that the taxpayer could 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. The advice cited *Starker v. U.S.*, 602 F.2d 1341 (9<sup>th</sup> Cir. 1979) (transfers need not occur simultaneously); *Coastal Terminals, Inc., v. U.S.*, 320 F.2d 333 (4<sup>th</sup> 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 (9<sup>th</sup> 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.

## **XVI. Build to Suit**

### **A. Parking Arrangements – In General**

Property may be improved or constructed while being “parked” with an accommodator, such as a qualified intermediary (QI) or exchange accommodation titleholder (EAT). In such build-to-suit arrangements, the taxpayer must avoid actual or constructive receipt of exchange proceeds. In a QI or QEAA safe harbor, legal fictions dispel issues involving agency and constructive receipt. 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 such 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.

### **B. Role of Qualified Intermediary**

If sufficient improvements to the replacement property can be made within the 180-day exchange period, and taking title to the replacement property before relinquishing property is not imperative, a deferred exchange under the Regulations would be structured. Construction would typically be 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.

### **C. Role of Exchange Accommodation Titleholder**

If construction can be done within 180 days, but the taxpayer must take title to the replacement property to be constructed prior to relinquish property, the transaction cannot, by definition, be structured as a deferred exchange. Rather, an exchange last reverse exchange would be required.<sup>75</sup> Since construction can be completed within 180 days, the safe harbor under Rev. Proc. 2000-37 would be employed. Under Rev. Proc. 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

### **D. 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 – whether or not the taxpayer has an urgent need to take title to the replacement property, 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 be avoided.<sup>76</sup> The accommodator in a non-safe harbor build-to-suit exchange should bear some risk of loss and incur some legal obligations.

### **E. Cases and Rulings Involving Build-to-Suit Exchanges**

#### **1. *Bloomington Coca-Cola v. Com'r***

*Bloomington Coca-Cola v. Com'r*, 189 F.2d 14 (7<sup>th</sup> 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

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<sup>75</sup> A build-to-suit reverse exchange will, by definition employ, 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.

<sup>76</sup> Neither a deferred exchange under the Regulations, nor an exchange structured under Rev. Proc. 2000-37 can accommodate a parking arrangement lasting more than 180 days. Therefore, a typical reason for choosing a reverse exchange, *i.e.*, that title must be taken to the replacement property immediately, would not be the rationale for engaging in a non safe harbor reverse exchange in this case.

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 acquired title to property 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 (4<sup>th</sup> 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 taxpayer’s property. Exchange treatment was accorded, since Y constructed the factory on its own behalf and not as an agent of taxpayer. Deferred exchange Regs. § 1.1031(k)-1(e) explicitly provide that replacement property may be constructed, and authorizes build-to-suit arrangements that have been adequately described during the identification period.

**5. 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 was accorded, 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.

6. **Fredericks v. Com'r**

*Fredericks v. Com'r*, T.C. Memo 1994-27 was decided prior to the enactment of the related party rules. *Fredericks* 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, 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 application of the 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.

7. **PLR 200901004**

In PLR 200901004, taxpayer was engaged in the business of processing minerals in Old Facility. To facilitate an exchange, the taxpayer 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. Ruling favorably, the ruling noted that the proposed exchange between the LLC and the taxpayer, although qualifying under

Section 1031, constituted an exchange of multiple properties, both tangible and intangible, pursuant to Treas. Regs. § 1.1031(j)-1. This necessitated a property-by-property comparison to determine the extent of any boot present in the exchange.

## **F. Summary of Build to Suit Cases and Rulings**

<b><u>Case or Ruling</u></b>	<b><u>Good Exchange?</u></b>	<b><u>Ruling</u></b>
<i>Bloomington Coca-Cola v. Com'r</i> 189 F.2d 14 (7 <sup>th</sup> Cir. 1951)	NO	Land conveyed to contractor in exchange for construction of Plant. Since taxpayer already owned land, taxpayer received services rather than qualifying real property in exchange.
<i>J.H. Baird v. Com'r</i> 39 T. C. 608 (1962)	YES	Broker bought property and constructed facility for taxpayer. Broker earned a profit and had not acted as taxpayer's agent.
<i>Coastal Terminals v. U.S.</i> 320 F.2d 444 (4 <sup>th</sup> Cir. 1963)	YES	Taxpayer transferred option acquire land to optionee, who used own funds to improve property. Optionee then transferred improved property to taxpayer in exchange for other real property. Optionee used own funds incurred own obligations, and was tax owner.
Rev. Rul. 75-291	YES	Y acquired land and constructed factory for purpose of exchanging it with taxpayer's property. Y was not an agent of taxpayer.
<i>Fredericks v. Com'r</i> T.C. Memo 1994-27	YES <sup>77</sup>	Transfer of apartment complex to wholly-owned corporation in exchange for corporation's promise to purchase and develop land resulted in good exchange since exchange was part of "integrated plan" and related party was not act as taxpayer's agent.
<i>DeCleene v. Com'r.</i> 115 T.C. 34 (2000)	NO	Taxpayer purchased unimproved land to be improved. Then, buyer expressed interest in other land owned by taxpayer. Taxpayer tried to structure exchange by "selling" unimproved land to buyer, engage buyer to make improvements, and then transfer improved land back to taxpayer in exchange for other appreciated property owned by taxpayer. Tax Court ruled no exchange, because "note" which taxpayer took in "sale" to buyer was non-recourse and interest free. Moreover, taxpayer guaranteed buyer's construction loan. Tax Court held buyer had never owned property, and therefore taxpayer had attempted to exchange property with itself. <i>Coastal Terminals</i> was distinguished in that in <i>Coastal Terminals</i> the taxpayer had not owned the land to be improved.
TAM 200039005	NO	After cash buyer failed to obtain financing, taxpayer engaged accommodator to take title to replacement property. Taxpayer remained liable on loan for replacement property and transferred relinquished property contract to accommodator. Exchange failed because accommodator acted as taxpayer's agent in acquiring replacement property.
PLR 200901004	YES	Taxpayer exchanged Old Facility for New Facility to be constructed by wholly-owned LLC. Since financing is secured by New Facility, and since lender can foreclose, wholly-owned LLC not acting as taxpayer's agent. PLR discusses multiple-asset ramifications of exchange.
CCA 200836034	YES	Taxpayer can combine reverse exchange under Rev. Proc. 2000-37 with deferred exchange under Treas. Regs. § 1.1031(k)-1(g)(4).

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*Fredericks v. Com'r* was decided prior to the enactment of the related party rules in IRC § 1031(f).

## **XVII. Tenancy-in-Common Interests and Undivided Fractional Interests**

### **A. Increased Popularity of TIC Interests**

Tenancy in common (TIC) interests have become 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 popularity of TICs as replacement property, the most desirable TIC investments command a 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 attractive 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 be 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.

#### **1. Mechanics of Investing in Tenancy in Common Interests**

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 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 either to sign a loan assumption agreement or agree to assume liability on all of the loan documents.

### **C. Tax Issues Involving TICs**

#### **1. TICs Not “Securities” For Purposes of Section 1031**

The term “securities” has a different meaning for securities law and tax law purposes. Under securities law, 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. Under the tax law, the term is defined narrowly. For purposes of Section 1031, the definition of “security” is limited to a stock, bond or note. Thus, there is little likelihood that an interest in a TIC (or DST) would violate Section 1031(a)(2)(C), which prohibits the exchange of “securities” in a like-kind exchange.

##### **a. Significance of Securities Law**

If TICs constitute securities for purposes of the securities laws, they should be sold only by brokers to “accredited” investors through a PPM which discloses risks. Congress has become concerned over the 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 “leveraging” 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.

#### **2. Illustration of Use of Tenancy in Common Interests**

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.<sup>78</sup>

**a.      Attractiveness of Oil and Gas as Replacement Properties**

Real estate owners may wish exchanging into a royalty stream in mineral rights or a working interest in an oil or gas property. Provided the rights are held for productive use in a trade or business, or for investment, acquisition of these interests would qualify under Section 1031. Rev. Rul. 68-331. Moreover, a working interest in an oil or gas well is not subject to the passive activity loss limitations of IRC § 469 provided the taxpayer holds the interest directly or through an entity in which liability is not limited. Therefore, current losses would be deductible. Although income from these activities would be ordinary rather than investment, the 15 percent yearly depletion deduction allowance would offset ordinary income.

**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 establish that the TIC interests do not constitute a tax partnership. In response to the explosion of TICs as replacement property, the IRS issued Rev. Proc. 2002-22, which permits the 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

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<sup>78</sup> 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. IRC § 1254.

as acquiring TIC interests or undivided fractional interests (UFIs), rather than 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 Rev. Proc. 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**

Rev. Proc. 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 is satisfied. However, even if all of the conditions are 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:

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 Rev. Proc. 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. Guidance From PLR 200513010**

The IRS had issued little guidance with respect to how the taxpayer could meet the prolific requirements of Rev. Proc. 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 Rev. Proc. 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.

**b. Overcoming Problem  
Requiring Unanimity of Tenants**

An important condition for obtaining a favorable ruling under Rev. Proc. 2002-22 is that tenants in common each have a right to participate in decisions regarding tenants and management. Implied consent may be used to minimize this problem. 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 Rev. Proc. 2002-22. 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.

**2. PLRs 200826005, 200829012 and 200829013**

In three recent PLRs, the IRS ruled that two 50 percent 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 percent tenancy-in-common ownership structures with regard to qualification as eligible replacement property. In approving a two-party 50 percent 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 his 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 percent owners, the restriction on the right of a co-owner to engage in activities that could diminish significantly the value of the other 50 percent 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 Rev. Proc. 2002-22 provides that each co-owner must share in any indebtedness secured by a blanket lien in proportion to his own indebtedness, the PLRs approved an arrangement whereby an owner who paid more than 50 percent would have a right to be indemnified by the other co-owner. Therefore, the Agreement provides a mechanism whereby the co-owners may 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 conducted 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 reclassification 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 reclassification 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 as owning 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 concluded:

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 is rather 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 (*e.g.*, Best Buy), but would not be an effective vehicle within which to own and operate multi-tenant commercial property.

## **XVIII. Partnership and LLC Exchange Transactions**

### **A. General Considerations**

#### **1. 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.<sup>79</sup>

#### **2. 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 partnership 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 determined at the partnership level. IRC § 702.

#### **3. 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

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<sup>79</sup> 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.

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.

#### **4. Partnership Must Avoid Termination**

When structuring partnership exchange transactions the partnership must avoid a termination under Section 708(b). 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.

#### **5. IRS Reporting Requirements for Partnership Exchanges**

The IRS has shows interest in partnerships that engage in like kind exchanges. Partnership income tax returns require information concerning like kind exchanges engaged in by the partnership. Question 13 of Schedule B of Form 1065 inquires as to whether

*during the current or prior tax year, the partnership distributed any property received in a like-kind exchange or contributed such property to another entity (other than entities wholly-owned by the partnership throughout the tax year.*

Question 14 asks whether

*[a]t any time during the tax year, [the partnership] distribute[d] to any partner a tenancy-in-common or other undivided interest in partnership property?*

#### **6. 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*, 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?

**a. Revenue Ruling 2003-56**

Revenue Ruling 2003-56 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.

**7. At-Risk Issues Involving Partnerships & 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.<sup>80</sup>

## **8. Passive Loss Issues Involving Partnerships & 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.

### **B. External Buyout of Partner’s Interest**

#### **Risk Assessment: LOW**

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 Buyout**

The most attractive feature of the external buyout 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 buy out is external, one would argue that the partnership has not been affected for purposes of Section 1031. An external buyout works best

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<sup>80</sup> 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.

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 Buyout**

As noted, the partners must provide cash to accomplish the buy out. Assume four partners have equal interests in a partnership, and 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 would have to be avoided.

## **3. Post-Exchange Financing**

As noted, the partnership will be required to exchange into property whose value is unreduced by any amounts paid for the partner being cashed out. 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-exchange loans, secured by the replacement property, may be at a lower interest rate than the pre-exchange loans incurred by the partners to purchase the other partners' interests.

## **4. 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. In addition, the pre-exchange bridge loan should not be collateralized by the relinquished property. In any event, since the partners whose interests are being bought out would probably not accept their sale being contingent on the partnership closing on the replacement property, as a practical matter this concern may be moot. Moreover, the economic 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, is precisely what minimizes the tax risks in structuring

the transaction in this manner.

## **5. 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. Under Section 754, a partnership may elect 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 so electing, 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 since it will increase depreciation deductions, and reduce gain when the partnership ultimately disposes of the replacement property.

### **a. Transfer of Partnership Interest Under IRC § 743**

Section 743 provides that where a partnership interest is sold or exchanged, and a Section 754 election is in effect, 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.

### **b. Distribution of Partnership Interest Under IRC § 734**

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.

## **C. Exchange Followed by Distribution “Swap and Drop”**

### **1. Distribution of Replacement Properties to Partners Following Exchange**

**Risk Assessment: LOW**

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 replacement properties for the purpose of holding them 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).<sup>81</sup>

**D. Distributing Interests Followed by Exchange “Drop and Swap”****1. Distribution of All Partnership Interests Followed by Separate Exchanges by Partners****Risk Assessment: LOW**

Suppose first that the partnership distributes tenancy in common interests to all partners. If all partners then engage in separate exchanges, receiving separate replacement property, will those exchanges qualify under Section 1031? The partnership would recognize no gain on the distribution of tenancy in common interests under IRC § 731(b). The distributee partners would also recognize no gain on the distribution and would take a basis in the distributed interest equal to their basis in the partnership interest under IRC Sections 731(a)(1) and 732(b). Since TIC interests will be created when the property is dropped out of the partnership, separate sale contracts should be entered into by the partnership and by the partners exchanging their tenancy in common interests. Partners should hold TIC interests before exchanging.

**2. Transfer Tax Considerations**

Additional transfer taxes will be generated by the distribution of tenancy in common interests. Following the distribution, ownership will

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<sup>81</sup> 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.

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 the step transaction doctrine. Therefore, the transaction should be planned before contract negotiations for the sale of the relinquished property commence.

**E.     Distribution of Single Tenancy in Common  
Partnership Interest Followed by Partnership Exchange**

**Risk Assessment: LOW to MODERATE**

Would the distribution of a 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. Separate sale contracts should be entered into by the partnership and by the partners.

**1.     Advance Planning Imperative**

Although time is not a luxury that partners wishing to dispose of partnership property can often afford, advance planning may 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" doctrine.

**2.     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 be 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. Structuring a drop and swap so that it meets as many of the criteria set forth in Rev. Proc. 2002-22 as possible would appear to be prudent. Rev. Proc. 2002-22 states that no ruling will be issued if the co-owners held the 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. To avoid a step transaction argument, the relinquished property should be distributed out of the partnership at an early juncture – prior to entering into a contract if at all possible.

**F. Cashing Out Using Installment Method**

**Risk Assessment: MODERATE**

**1. 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 consideration. The installment note is transferred directly to the partnership in a taxable sale. Prop. Reg. § 1.453-1(f)(1)(iii) provides for the timing of gain upon receipt of an installment obligation received in a like kind exchange. Installment notes

(which qualify for installment reporting) received in a like kind exchange are not taxed as the time of the exchange. Rather, as payments are received on the installment obligation, a portion of each payment is taxed as gain, and a portion constitutes a recovery of basis. Therefore, no gain will be recognized by the partnership upon receipt of the installment note.

## **2. 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 could be secured by a nonnegotiable commercial standby letter of credit without resulting in the receipt of the note by the partnership being considered “payment.”

## **3. 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 to the buyer.<sup>82</sup>

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 three percent on January 1<sup>st</sup> of the following year. If the note qualifies as

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<sup>82</sup> Regs. § 1.1031(k)-1(g)(4)(iv)(B). This will avoid the imposition of one real property transfer tax.

an installment obligation<sup>83</sup>, boot gain will be shifted from the partnership to C. In exchange for this note, the partnership conveys the remaining one-third undivided interest in the property to the cash 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.<sup>84</sup> C will recognize gain on each payment made under the installment note using the installment method as provided in IRC § 453(c).<sup>85</sup> 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 partnership will violate the special allocation rules.<sup>86</sup>

#### **4. Obtaining Letters of Credit**

A commercial bank will 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, will have to obtain a letter of credit. Since obtaining such letters of credit are no longer a ministerial matter, the letter of credit should be arranged well in advance of closing. The partner receiving the promissory note must be willing to forego the receipt of interest for a short period of time.

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<sup>83</sup> 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).

<sup>84</sup> IRC § 732(b).

<sup>85</sup> 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.

<sup>86</sup> 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.

## 5. 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 would pursue a like kind exchange. Shortly after the acquisition of replacement property, the partnership would likely engage in post-exchange financing to pay off the installment note held by the partner who was redeemed. The payments would out over two taxable years, in the same manner as described above, where the purchaser provided the installment note.

## 6. 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 in the active conduct of a trade or business or for investment. However, despite the allure of the installment note method, there are numerous exceptions to nonrecognition under Section 453 whose potential application should be carefully analyzed.

## G. Distribution of All TIC Interests Followed by One Partner Cashing Out

### **Risk Assessment: MODERATE**

Suppose the partnership distributes TIC interests to all partners and, after sufficient time, one partner sells his TIC interest for cash and pays capital gains tax, while the other partners swap their TIC interests and acquire either a single replacement property or separate replacement properties. Will the partnership's exchange be respected? The qualified use requirement appears to have been satisfied. However, the receipt of cash by one partner 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.

## H. May Partners Make Special Allocations of Gain?

### **Risk Assessment: MODERATE**

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 the 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”<sup>87</sup>; (ii) the allocation is in accordance with the partners’ interests in the partnership<sup>88</sup>; or (iii) the allocation is in accordance with IRC § 704(c)<sup>89</sup>.

## **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 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

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<sup>87</sup> IRC §704(b) and Regs. §1.704-1(b)(2).

<sup>88</sup> IRC §704(b) and Regs. §1.704-1(b)(3).

<sup>89</sup> See Regs. §1.704-1(b)(2)(iv)(f) and Regs. §1.704-3(a)(6).

“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**

Partnership allocations are often 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 substantially affects the dollar 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 that 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.

**I. Partnership Exchange Followed  
by Direct-Deeding to Partners**

**Risk Assessment: HIGH**

Would the requirements of the deferred exchange rules be satisfied if the partnership or LLC directed the QI to transfer title in the replacement property directly to partners following an exchange by the LLC? Under the “aggregate” theory, the partnership is ignored for purposes of computing federal income tax. However, the partnership is not ignored for purposes of satisfying the like kind exchange requirement. Regs. §1.1002-1(d) comprehends 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.

**J. Elect Out of Subchapter K**

**Risk Assessment: HIGH**

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.<sup>90</sup> 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.

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Regs. § 1.761-2(a)(2).

**K. Summary of Hypothetical Partnership Transactions (In increasing Risk)**

<u>Hypothetical Transaction</u>	<u>Transaction</u>	<u>Qualified Use Violated?</u>	<u>Rationale</u>
Partnership Transaction #1	External buyout of partner's interests followed by exchange Risk: Low	NO	Partnership holds relinquished and replacement property for required purpose; however, non-tax issues may make unattractive
Partnership Transaction #2 ("Swap & Drop")	Distribution of all TIC interests, followed by separate exchanges by partners Risk: Low	NO?	Since separate TIC interests will be created upon distribution, separate sales contracts should be entered into; attempt to satisfy requirements of Rev. Proc. 2002-22. <i>Mason v. Com'</i> .
Partnership Transaction #3 ("Drop & Swap")	Distribution of replacement properties to partners following exchange Risk: Low	NO?	<i>Maloney v. Com'r</i> , 93 T.C. 89 (1989) Partnership should not immediately Distribute replacement property
Partnership Transaction #4	Distribution of single TIC interest, followed by partnership exchange Risk: Low to Moderate	NO?	IRS could assert "exchange" consisted of exchange by tax partnership; see Rev. Proc. 2002-22
Partnership Transaction #5	Partner's interest redeemed for for cash and note; partnership exchange Risk: Moderate	NO?	IRS could argue "exchange" consisted of exchange by tax partnership, yet partnership appears to have good exchange
Partnership Transaction #6	Distribution of all TIC interests, followed by one partner cashing out Risk: Moderate	NO?	Presence of cash increases likelihood of IRS asserting that a prohibited exchange of partnership interests has occurred.
Partnership Transaction #7	Special allocation of gain Risk: Moderate	NO?	Theoretically possible, but meeting requirements of regulations under Section 704(b) may be difficult
Partnership Transaction #8	Partnership exchange followed by direct-deeding to partners Risk: High	UNCLEAR	Partnership apparently cannot meet "qualified use" test if partnership never acquires replacement property
Partnership Transaction #9	Election out of Subchapter K Risk: Very High	YES?	Requirement that partners not "actively conduct" business may doom

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